[JOINT COMMITTEE PRINT]

DESCRIPTION OF POSSIBLE OPTIONS TO INCREASE REVENUES

PREPARED FOR THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

BY THE STAFF OF THE

JOINT COMMITTEE ON TAXATION

WITH THE STAFF OF THE

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INTRODUCTION

This pamphlet, prepared by the staff of the Joint Committee on Taxation in conjunction with the staff of the Senate Committee on Finance, provides descriptions of possible revenue-increase options for the information of the Committee on Finance in connection with any consideration of revenue-increase legislation.

The first part of the pamphlet is a description of provisions addressed by the Administration's revenue proposals. This is followed by a description of other possible revenue-increase options that have been proposed by Senators or that the Finance Committee may wish to consider. For each of the proposals in parts I and II, the description includes present law, possible alternative proposals, pros and cons, and estimated revenue effects. The third part is a tabulation of the estimated revenue effects of the proposals described in parts I and II of this pamphlet. Finally, an Appendix presents data, by income class, of estimated taxable returns, total tax liability, average tax liability, and percentage of taxpayers itemizing deductions in 1983 and 1984 (under present law).

The proposals described in part II of this pamphlet are not Joint Committee staff or Finance Committee staff proposals or recommendations, but rather possible revenue-increase options which the Finance Committee may wish to consider in connection with legislation relating to revenue-increase targets set by the Congressional Budget Resolution.

I. PROVISIONS ADDRESSED BY ADMINISTRATION PROPOSALS

A. Accounting for Long-Term Contracts

Present Law

Overview

A taxpayer which enters into long-term contracts may elect to use one of four accounting methods to account for the income and expenses attributable to such contracts. Long-term contracts generally are contracts that are not completed by the end of the taxable year in which they were entered into.

The four methods are the cash method, the accrual method, the percentage of completion method, and the completed contract method. The cash and accrual methods are methods applicable to all types of income of all taxpayers generally. The percentage of completion method and the completed contract method apply only to long-term contracts.

Cash method

Under the cash method, income is reported for the year in which it is actually or constructively received. Deductions generally are taken for the year in which actually paid. Therefore, a taxpayer who uses the cash method to account for income and expenses for long-term contracts includes payments in income when received (either before or after completion of the contract) and takes deductions for expenses when actually paid.

Accrual method

Under the accrual method, income is generally reported when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy, regardless of when it is received. However, special rules apply to payments received on a long-term contract before completion of the contract. These "advance" payments generally are includible in income when received, but the taxpayer generally may elect to defer inclusion until the year income would be includible under its method of accounting for tax purposes or, if earlier, the year income would be includible under its method of accounting for financial reporting purposes (e.g., the year the goods are shipped).

If an accrual basis taxpayer does not use inventories in connection with a long-term contract, deductions generally are allowed for the year in which all events have occurred which determine the fact of liability and the amount thereof can be determined with reasonable accuracy. If the taxpayer uses inventories, costs allocable to inventory are accumulated until the inventory is shipped, delivered, or accepted.

Percentage of completion method

Under the percentage of completion method (which is used only for long-term contracts), income is recognized according to the percentage of the contract that is completed during each taxable year. The computation of how much of the contract is completed during a taxable year may be made by comparing (1) the costs incurred during the year to the total estimated costs of the contract or (2) the physical work performed on the contract during the year to the total estimated work to be performed. Expenses of the long-term contract are deductible for the year in which paid or incurred.

Completed contract method

Inclusion in income

Under the completed contract method (which is used only for long-term contracts), income from the contract is includible in income for the year in which the contract is completed, unless the taxpayer elects to include advance payments in income when received.

The present Treasury regulations provide that a contract will not be considered completed until final completion and acceptance have occurred. Nevertheless, a taxpayer may not delay the completion of a contract for the principal purpose of deferring income tax. In addition, the present regulations provide that several agreements generally will not be treated as a single contract unless the several agreements would be treated as one contract under customary commercial practice or unless there is no business purpose for entering into several agreements rather than one agreement.

The Administration has announced that it proposes to amend these regulations to provide a more detailed set of rules for determining when a contract is completed and when agreements should be treated as one contract or more than one contract.

The Treasury Department has stated that the revised regulations would provide that agreements to produce items which are independently priced would be treated as separate contracts. In addition, the exercise of an option to acquire additional items or the issuance of a change order to increase the number of items would be treated as a new contract. Further, the revised regulations would provide that the completion of a contract will not be delayed by reason of (1) contingent payment of amounts based upon the performance of the item or (2) a provision to provide replacement parts or to supervise installation.

Deduction of expenses

Under the completed contract method, expenses allocable to the contract (commonly referred to as "contract costs") are deductible for the year in which the contract is completed. Expenses that are not allocated to the contract (commonly referred to as "period costs") are deductible for the year in which they are paid or incurred.

Under existing regulations, contract costs include all direct expenses and indirect expenses that are incident and necessary to the performance of the contract, with the following exceptions (which are currently deductible as period costs):

(a) Marketing and selling expenses, including bidding expenses;

(b) Advertising expenses;

(c) Other distribution expenses;
(d) General and administrative expenses which benefit the taxpayer's business as a whole;
(e) Interest;
(f) Research and development expenses;
(g) Losses;
(h) Percentage depletion in excess of cost depletion;
(i) Depreciation on idle equipment and, for other equipment, tax depreciation in excess of book depreciation;
(j) Income taxes;
(k) Pension and profit-sharing contributions and other employee benefits;
(l) Costs attributable to strikes, rework, scrap, and spoilage; and
(m) Officer compensation which benefits the taxpayer's activities as a whole.

The Administration has proposed modifying these regulations. Under the revised regulations, all costs of the taxpayer would be allocated to the contract other than the following expenses (which could continue to be deducted currently as period costs):

(1) General marketing, selling, and advertising expenses;
(2) Bidding expenses incurred in the solicitation of contracts not awarded to the taxpayer;
(3) Research and experimental expenses neither directly attributable to particular long-term contracts in existence at the time such expenses are incurred, nor incurred under an agreement to perform such research and experimentation;
(4) Losses;
(5) Depreciation and amortization on idle requirement and facilities;
(6) Income taxes attributable to income received from long-term contracts;
(7) Pension contributions to the extent representing past service costs; and
(8) Costs attributable to strikes.

Administration Proposal

Taxpayers having long-term contracts would be required to account for income from those contracts under the percentage of completion method or the progress payment method. The cash method, the completed contract method, and the accrual method could not be used to account for income and expenses under long-term contracts. The percentage of completion method would be the method described in present law.

The progress payment method would be a new method, which would be similar to the cash method. Under the progress payment method, the taxpayer would include in income all payments when received or when the taxpayer has a right to receive the payment. ("Payment" would include, for example, amounts loaned to the taxpayer from the purchaser.) Payments received prior to the commencement of work on the contract would be treated as received over a 12-month period (or longer period with the approval of the Internal Revenue Service).

Under the progress payment method, costs allocable to the contract generally would be deductible only when, and to the extent, the taxpayer includes payments in income. Costs exceeding payments could be deducted only when, and to the extent, the cumulative costs exceed the total amount the taxpayer has a right to receive under the contract. The determination of how much income or expenses are to be recognized would be made on a contract-by-contract basis. Thus, costs from one contract could not offset income from another contract. Costs allocable to the contract would be those costs allocated to the contract under the revised regulations.

Possible Modifications to Administration Proposal

1. Safe-harbor rule for percentage of completion method

Under the percentage of completion method, a taxpayer takes deductions as they are paid or incurred and recognizes income according to estimates of how much of the contract was completed during the year. Under a possible safe-harbor rule, this estimate could be based on the average profit the taxpayer realized on long-term contracts completed during the 3-year period before he entered into the current contract.

For example, if the average profit on completed contracts for the 3-year period is 5 percent of the costs incurred for such contracts, then the taxpayer would include in income 105 percent of the costs incurred in each taxable year, but not to exceed the total amount of income to be realized from the contract. If, before completion of the contract, the costs incurred to date exceeded the total income to be realized, a loss would be allowed.

For taxpayers with less than 3 years of experience, the average profit percentage to be used under the safe-harbor rule could be zero, which would result in income recognition as if the completed contract method had been used.

2. Modified completed contract method

Under a modified completed contract method, the income and expenses allocated to the contract could be taken into account in the year that the contract is completed (as under present law), but an interest charge could be imposed to compensate for the delayed reporting of income or loss inherent in the completed contract method. This could be accomplished most easily by allocating the income or loss from the contract to each year of its life on the basis of total costs, direct labor, or other reasonable method, then increasing that income or loss by an interest charge, and reporting the total increased income or loss in the year the contract is completed.

The interest rate could be set at the present law rate for deficiencies, in which case any additional tax attributable to the interest charge on a contract profit would be treated as a deductible interest expense. As a corollary, when taxes are reduced because a loss is increased by an interest charge, the reduction in tax attributable to the "interest" portion of the loss would be treated as interest income. Alternatively, the interest rate could be set at the equivalent of an after-tax deficiency rate (e.g., 50 percent of the present law deficiency rate), in which case increases or decreases in tax would not be treated as interest expense or income.

3. Exemption for small business

Under this modification, small businesses would be exempt from the restriction that income from long-term contracts must be accounted for under either the percentage of completion method, progress payment method, or the modified completed contract method. Thus, small businesses could also use the cash method, accrual method, or the regular completed contract method. A small business could be defined as a company whose average gross receipts from long-term contracts over the preceding 3 years is less than $10 million.

4. Progress payment method

It could be decided not to adopt the progress payment method under the Administration proposal, or the method could be adopted with restrictions so that it would not apply to the first 2 taxable years in which a long-term contract is in effect. Under the latter alternative, all payments received in excess of costs incurred during the first 3 taxable years of a contract would be includible in income for the third taxable year.

5. Partial use of completed contract method

Under this modification, all taxpayers could be permitted to defer a portion of their profits on long-term contracts until the contract is completed as if the completed contract method were used to account for a portion of each long-term contract. For taxpayers using the safe-harbor rule under the percentage of completion method, only a fraction of the safe-harbor percentage would be used. For taxpayers using the modified completed contract method, there would be no interest charge for any income or loss on the portion of the contract accounted for under this modification.

6. Phase-in

If the increase in tax payments resulting from the Administration proposal (or any modifications to the proposal) is considered too severe, the Administration proposal (or modifications) could be phased in over a specified period.

7. Regulatory approach

The legislative proposal could be deleted, and the Treasury Department could be instructed to proceed with the regulatory changes, including a review of the treatment of the self-constructed assets and multi-unit long-term contracts.

Pros and Cons

Arguments for the proposals

In general.—For financial accounting purposes, the percentage of completion method is the method generally used to account for income from long-term contracts. This is because that method most closely matches income and costs, and thereby reflects the amount of income earned in each accounting period. By constrast, a method that does not currently recognize income until completion of the contract—such as the completed contract method—defers recognition of income beyond the accounting periods to which income properly belongs.

Administration proposal.—The proposal would prevent the deferred reporting of income from long-term contracts by requiring current recognition of income under either the percentage of completion method or the progress payment method. The progress payment method requires payment of taxes on cash income of a taxpayer and should ensure that the taxpayer has the cash with which to pay the tax.

Safe harbor for percentage of completion method.—Under this possible modification, disagreements between taxpayers and the Internal Revenue Service under the percentage of completion method (relating to the expected profit on the contract and the amount completed during a particular year) would be avoided through a safe-harbor rule which would be based on the historical profitability of the taxpayer.

Modified completed contract method.—The modified completed contract method would allow all of the advantages of the completed contract method (e.g., assurance that the contract is profitable before imposition of a tax) while removing the benefits of deferral implicit in the regular completed contract method.

Small business exception.—This modification would permit small businesses to continue to use the cash, accrual, and completed contract methods.

Two-year grace period for progress payment method.—This modification would ensure that the progress payment method would not unfairly tax advance payments and would effectively exempt most contracts of small businesses.

Partial use of completed contract method.—This possible modification would allow a partial removal of the benefits of deferral by providing that a percentage of income for each year could be deferred until completion of the contract.

Phase-in.—This modification would provide a gradual transition to more current income reporting.

Regulatory approach.—This possibility would permit continued use of the completed contract method, but would reduce the amount of deferral of income by providing a clearer reflection of income.

Arguments against the proposals

1. It is not generally accepted accounting theory that the percentage of completion method is the only method which can be used to account for the income from long-term contracts. Therefore, any comparison of other methods to the percentage of completion method cannot show that such other methods result in "deferral" of income recognition, any more than it can show any "acceleration" of income recognition under the percentage of completion method.

2. The cash and completed contract methods are simple methods that are often used by small businesses for both tax and financial purposes. To require small businesses to use more complex methods for tax purposes would be unduly burdensome.

3. Until a contract is completed, it may not be possible to know whether there is a profit or loss or the amount of any profit or loss. To require use of the percentage of completion method could result in the taxation of nonexistent profits before the contract is completed.

4. The legislative proposals would have an inflationary impact because the increased administrative costs of the more complex account-

ing methods and the cost of earlier or increased tax payments would tend to raise the purchaser's cost under the contract. Some of these costs would be borne directly by the Federal Government in the form of higher defense procurement costs.

5. The progress payment method provides a tax on cash flow, not income. As such, the amount of the tax depends on the bargaining strength of the parties over whether amounts must be borrowed or advanced by the buyer; it has no relationship to income.

Revenue Effect

[Fiscal years, billions of dollars]

Item	1983	1984	1985	1986	1987
Administration proposal	2.0	4.4	4.5	3.9	3.8

B. Tax-Exempt Bonds for Private Activities

Present Law

General rule

Interest on State and local government obligations generally is exempt from Federal income tax. However, subject to certain exceptions, interest on State and local issues of industrial development bonds (IDBs) is taxable. An obligation is an IDB if (1) all or a major portion of the proceeds of the issue are to be used in any trade or business of a person other than a governmental unit or tax-exempt organization (described in sec. 501(c)(3)), and (2) payment of principal or interest is secured by an interest in, or derived from payments with respect to, property or borrowed money used in a trade or business.

Exceptions for certain financings

Present law provides an exception which exempts from tax interest on IDBs that are issued to finance the following types of facilities: (1) projects for residential rental property, (2) sports facilities, (3) convention or trade show facilities, (4) airports, docks, wharves, mass commuting facilities, and parking facilities, (5) sewage and solid waste disposal facilities, and facilities for the local furnishing of electricity or gas, (6) air or water pollution control facilities, (7) certain facilities for the furnishing of water, (8) qualified hydroelectric generating facilities, and (9) qualified mass commuting vehicles. In addition, the interest on certain obligations issued for the purpose of acquiring or developing land as a site for an industrial park is exempt from taxation.

Present law also allows tax-exempt financing for student loans and organizations that qualify for tax exemption under section 501(c)(3), such as private, nonprofit hospitals and private, nonprofit educational institutions. In addition, mortgage revenue bonds to finance certain owner-occupied housing are eligible for tax-exempt financing through 1983.

"Small issue" exception

Present law also provides an exception to the general rule of taxability for interest paid on IDBs for certain "small issues". The interest on small issue IDBs is exempt if the proceeds are used for the acquisition, construction, or improvement of land or depreciable property. This exception applies to issues of $1 million or less or, at the election of the taxpayer, the limitation may be increased to $10 million, subject to certain restrictions.

Both the $1 million and $10 million limitations are determined by aggregating the face amount of all outstanding small issues for all facilities used by the same or related principal users which are located within the same county or same incorporated municipality. In addition, the $10 million limitation is reduced to the extent that principal

users of the facilities incur certain capital expenditures in the same county or same incorporated municipality.

Other rules

Under present law, facilities financed with tax-exempt IDBs may be depreciated under the Accelerated Cost Recovery System (ACRS). Also, the Internal Revenue Service has held that the tax exemption for interest on certain issues of industrial and agricultural development bonds will be denied when several small issues are pooled and issued as a single bond offering under "umbrella" bond programs (Rev. Rul. 81–216; Proposed Treas. Reg. sec. 1.103–7(b)(6)).

Arbitrage bonds

Interest on State and local government obligations generally is taxable if the bond proceeds are used to acquire other securities with a materially higher yield ("arbitrage bonds"). However, under present law, an obligation is not characterized as an arbitrage bond merely because bond proceeds are invested in securities with a materially higher yield during a temporary construction period or become part of reasonable reserve funds. Present law is unclear whether the proceeds of the issue should be reduced by issuance costs in determining the yield on the bonds.

Administration Proposals

Restrictions on private-purpose bonds

New restrictions would be imposed on the issuance of tax-exempt bonds for private purposes (IDBs, bonds financing Federally guaranteed student loans, and bonds issued for section 501(c)(3) organizations):

(a) An issue would have to be approved, after a public hearing, by either the highest elected official or legislative body of the governmental unit which issued the bonds (or on whose behalf the bonds are issued) and the governmental unit(s) in which the facilities financed by the bonds are located, or by the public in a voter referendum.

(b) A governmental unit issuing bonds after December 31, 1985, would be required to make a financial contribution of one percent of the cost of the project (such as excepting the project from property taxes) that is financed with the bond proceeds or to provide a financial commitment (such as a guarantee or surety for the bonds).

(c) Private purpose bonds would be required to be in registered form and their issuance reported by the State or local government to the Internal Revenue Service.

(d) Taxpayers would be required to recover the costs of depreciable assets financed with any IDBs using straight-line depreciation over the extended recovery periods used for earnings and profits computation purposes. These extended recovery periods are 5 years for property in the 3-year class, 12 years for property in the 5-year class, 25 years for property in the 10-year class, and 35 years for property in the 15-year class.

Additional limitations on small issue IDBs

The use of tax-exempt small issue IDBs would be eliminated for large businesses, defined as businesses with total capital expenditures

of more than $20 million worldwide during the period beginning 6 years before the issuance of the bonds. In addition, bonds would not qualify as exempt small issue IDBs if the business would have more than $10 million of industrial development bonds outstanding after issuance of the bonds. With these restrictions, small issue IDBs would be allowed as a part of a composite or umbrella issue of bonds.

Arbitrage bonds

The exception from classification as an arbitrage bond for reserve funds and funds held for a temporary construction period for private purpose bonds would be eliminated. In addition, the proposal would clarify that the yield on the bonds would be computed on the basis that the issuance price of the bonds is not reduced by issuance expenses.

Alternatives to Administration Proposals

1. Approval requirement

The approval rule could be deleted for some or all types of private purpose bonds. For example, the requirement could be modified so that it would not apply to student loan bonds.

2. Financial contribution requirement

The financial contribution requirement could be deleted with respect to certain types of bonds. Alternatively, the amount of the required financial contribution could be reduced below the one-percent requirement of the Administration proposal.

3. Anti-double dip requirement

The Administration proposal that requires the cost of assets financed with tax-exempt bonds to be recovered using the straight-line method over the extended recovery periods used for earnings and profits computations (referred to as the "anti-double dip requirement") could be modified so that it would not apply to certain types of bonds in cases where extraordinary levels of subsidy are deemed appropriate. For example, the requirement could be deleted for bonds for multi-family rental projects or for solid waste disposal facilities that process municipal waste. As a further example, the requirement could be applied only to small issue bonds.

Alternatively, the effect of the anti-double dip requirement can be reduced by providing cost recovery methods that are more generous than the straight-line, earnings and profits lives methods of the Administration proposal, but less generous than the entire benefits of ACRS. For example, the proposal could be modified so that facilities financed with tax-exempt bonds would be depreciated over lives used in computing the cost recovery deductions under the minimum tax (i.e., 5 years for 3-year property, 8 years for 5-year property, 15 years for 10-year property, 22 years for 15-year public utility property, and 15 years for 15-year real property). This alternative could be combined with the first alternative to provide various levels of subsidy for different types of bonds.

As a third alternative, the anti-double dip requirement could be relaxed or eliminated for small businesses. This alternative could be combined with either of the first two alternatives to provide various

levels of subsidy for various types of bonds used by various sizes of businesses.

4. Student loan bonds

As an alternative, or in conjunction with other requirements, new limitations could be placed on the use of tax-exempt bonds to finance student loans. For example, student loan bonds coud be limited to students of families whose income is under a set figure (e.g., $50,000). Further, the volume of student loan bonds that any State could issue could be limited to an amount which varies with its population (e.g., $20 per capita).

Consideration could be given to broadening the Administration's proposal to apply any limitations to all tax-exempt bonds that finance student loans, whether or not the student loans are guaranteed by the Federal Government.

5. Small issue bonds

The Administration proposal eliminating the use of small issue bonds by large businesses could be modified. As an alternative, or in conjunction with the Administration proposal, new limitations could be placed on the use of small issue bonds.

a. *Definition of large business.*—The definition of large businesses could be modified by either increasing or decreasing the amount of permitted capital expenditures, shortening the measuring period, or adopting a different measurement of size (e.g., number of shareholders, number of employees, amount of paid-in capital, annual gross receipts, whether stock is publicly traded, etc.).

b. *Restriction of small issue bonds to certain uses.*—Small issue bonds could be limited to certain types of uses. For example, small issue bonds could be restricted to industrial use and denied to commercial use. The definition of commercial could be defined by reference to a uniform classification e.g., SIC code).

Alternatively, the use of small issue bonds could be denied to certain specified uses. For example, small issue financing could be denied to certain sports facilities, professional offices (e.g., doctors or lawyers offices), etc.

c. *Geographical targeting.*—The use of small issue bonds could be limited to certain geographical areas. In the alternative, new restrictions on the use of small issue bonds or private purpose bonds could be relaxed or eliminated in targeted areas. Targeted areas could be (i) areas eligible for urban development action grants (UDAG), (ii) areas eligible under the Administration's proposal as enterprise zones, (iii) areas of chronic economic distress (as defined in the limitations on mortgage subsidy bonds), etc.

d. *Volume limitations.*—The dollar volume of small issue bonds that are permitted to be issued within any State could be limited. For example, the maximum volume of small issue bonds that any State could issue during any calendar year could be limited to $50 per capita.

e. *Combinations of limitations.*—It is possible to combine some or all of the above limitations. For example, it would be possible to limit small issue bonds to industrial uses except in designated targeted areas. Similarly, it would be possible to limit small issue bonds to small businesses except in designated targeted areas.

Pros and Cons

Arguments for the proposals

1. The proposals would limit the volume of private purpose tax-exempt bonds. This, in turn, would (a) help restore the benefit of tax-exempt financing for traditional governmental purposes and (b) reduce the growing Federal revenue loss attributable to the increasing volume of private purpose tax-exempt obligations.

2. Tax-exempt bonds are an inefficient method of providing a subsidy. Historically, the ratio of interest rates on tax-exempt bonds to the interest rates on taxable bonds has averaged between 65 and 70 percent. At that ratio, the Federal Government loses approximately $3 of tax revenue for every $2 of benefit to the person for whom the bonds were issued. Recently, this interest rate ratio has increased to 80 percent and above, further reducing the efficiency of the method. As more tax-exempt bonds are issued, the ratio will increase further.

3. Tax-exempt IDBs provide a competitive advantage to those companies which remain eligible to use them.

4. Since IDBs generally are issued by all communities, IDBs do not provide an incentive for a business to locate in one community over another.

5. The requirement that private purpose bonds be approved after a public hearing by the highest elected official or an elected legislative body would allow citizens who do not approve of the subsidy to raise objections to the issuance of the bonds and, thereby, improve the responsiveness of State and local governments to their citizens. The public should have an opportunity to object to the use of tax-exempt bonds for all private purpose obligations. The higher the volume of private purpose obligations, the higher the interest rates paid by State and local governments on obligations used for traditional purposes and the higher the resulting State and local taxes.

6. The requirement that State and local governments contribute or financially commit themselves to a project would better ensure that the State and local governments make a meaningful determination that the bonds will be used for a valid public purpose. Moreover, many State and local governments already contribute toward these projects in the form of property tax abatements, provision of special roads, sewers, etc.

7. The requirement that business users of tax-exempt bonds choose between the benefits of tax-exempt financing and the benefits from ACRS would eliminate double tax benefits which often result in substantial negative effective tax rates. Negative tax rates tend to distort the allocation of capital and to encourage otherwise unprofitable investment. Moreover, this requirement would raise revenue even if the volume of bonds is not decreased, since bond users would have lower cost recovery deductions.

8. The Administration proposal would eliminate use of small issue IDBs by large corporations which do not need tax-exempt financing to raise investment capital. Moreover, the proposal would allow the use of composite or umbrella issues of IDBs and, thus, would extend the benefits of tax-exempt financing to more small businesses by reducing the cost of issuing tax-exempt bonds. Alternatives that would deny

small issue bonds for commercial uses would be arbitrary and difficult to enforce; would remove the flexibility that permits governments to determine what is best for their localities; would deny use to commercial businesses which generally are more labor intensive in unskilled workers than industrial businesses; and would deny use of small issue bonds in parts of the country where commercial activity is the major business. Alternatives that would target small issue bonds to certain geographical areas (or provide more generous rules in certain geographical areas) would operate arbitrarily and tend to lower business activity in healthy areas. Alternatives that limit the volume of small issue bonds that can be issued would tend to delay the issuance process and would not account for the different needs of different areas.

9. A requirement that bonds be registered would reduce the possibility for use of tax-exempt bonds to evade income or estate tax liability.

10. A requirement that information concerning bond issues be reported to the Internal Revenue Service would provide information to the Congress and others needed to monitor the tax-exempt bond program and help enforce restrictions on IDBs.

11. Private purpose tax-exempt bonds should not be allowed to be used to obtain substantial arbitrage profits on reserve funds and funds held during temporary construction periods, since this encourages issuance of more bonds in order to benefit from larger reserves and encourages the issuance of bonds before the funds are necessary.

Arguments against the proposals

1. No restrictions should be placed on the use of private purpose tax-exempt bonds since these bonds constitute an economic development tool for local communities which can attract private investment capital and create job opportunities. Current high interest rates, high unemployment, and the needs of the communities to have economic development tools necessitate that no new restrictions be placed on the use of IDBs.

2. Tax-exempt bonds provide a subsidy to economic development with a minimum of Federal involvement.

3. The requirement of a public hearing and approval for each bond issue would limit the flexibility in timing bond sales and create delays in securing bond proceeds. In addition, the approval requirement is intended to allow persons disadvantaged by tax-exempt financing an opportunity to express their concerns to elected persons. This policy does not apply to certain types of bonds where the bond proceeds are not used in trades or businesses that compete with other trades or businesses (e.g., student loans).

4. A requirement of a financial contribution by the governmental unit issuing the bond is unreasonable, since many local governments could not afford it and some State constitutions prohibit certain types of such contributions.

5. The requirement that would force businesses to make a choice between use of IDB financing or use of ACRS runs counter to the Administration's goal of economic recovery. The use of IDBs or ACRS should not be mutually exclusive, since certain worthwhile investments should benefit from both. Moreover, in the case of certain types of projects, higher levels of subsidy are needed to insure that these proj-

ects will be built. For example, some have contended that higher subsidy levels are needed for multi-family rental projects and solid waste disposal facilities for the processing of municipal waste. In the case of certain types of assets, the tax benefits after the Administration proposals would be less than those that existed before ERTA. The depreciable life of the assets financed with tax-exempt bonds should be adjusted so that no group of assets is in a worse position than prior to ERTA.

6. The proposed requirement that would restrict the use of small issue IDBs to small businesses would be inappropriate because it is often necessary to have a large, financially strong companies involved in a project in order to make it economically viable. Moreover, larger companies may provide more secure jobs and better benefits to their employees. On the other hand, the alleged abuses of small issue bonds occur where they have been used for commercial uses and, consequently, only commercial use of the small issue bonds should be limited. Similarly, certain distressed areas need both higher levels of subsidy and the ability to encourage large, financially strong companies to invest in them in order to provide a sound business foundation with which to attract other businesses. Appropriate State volume restrictions limit the Federal revenue loss and tend to force States to allocate the limited subsidy to the more meritorious projects, while retaining the flexibility necessary for States to vary their bond programs in accordance with their different needs.

7. Registration and reporting requirements would impose unnecessary burdens and increase the administrative costs to the State and local governments issuing bonds.

8. The restrictions on arbitrage from reserves and temporary construction period investments would reduce the profits from these sources which are typically devoted to financing the project, so that higher amounts of tax-exempt bonds would be issued to finance a project.

Revenue Effect

[Fiscal years, billions of dollars]

Item	1983	1984	1985	1986	1987
Administration proposal	(1)	.5	1.3	2.6	4.1

[1] Increase of less than $50 million.

C. Taxation of Life Insurance Companies

Present Law

Introduction

Generally, a life insurance company receives income from two primary sources: the premiums it receives from policyholders, and investment earnings on the portion of premiums set aside to pay future claims. Although life insurance companies pay income tax at the regular corporate rates, the tax rates are applied to a tax base determined in a special manner.

Taxable income

The regular corporate income tax rates are imposed on "life insurance company taxable income," which is defined as the sum of:

(1) the lesser of (a) taxable investment income or (b) gain from operations;

(2) 50 percent of the amount by which the gain from operations exceeds taxable investment income; and

(3) amounts subtracted from the policyholders' surplus account for the taxable year.

To describe generally a company's applicable tax base, a company is commonly referred to as a "phase I company" if the tax base is taxable investment income; a "phase II negative" company if the tax base is gain from operations which is less than taxable investment income; and a "phase II positive" company if the tax base is the sum of taxable investment income and 50 percent of the excess gain from operations.

The 50-percent portion of gain from operations in excess of taxable investment income that is not taxed currently under (2) above must be added to the policyholders' surplus account and is taxed when distributed from that account.

Taxable investment income

In determining taxable investment income, there first is excluded the portion of the "investment yield" treated as the policyholders' share, i.e., the portion necessary to fund future claims. The "investment yield" means gross investment income (interest, dividends, rents, royalties, short-term capital gains, and trade or business income) reduced by certain deductions (investment expenses, real estate expenses, depreciation, depletion, and trade or business expenses).

The excludable portion treated as the policyholders' share of investment yield is determined by allocating the portion of each item of investment yield which reflects the percentage obtained by dividing the "policy and other contract liability requirements" by the investment yield. For this purpose, the liabilities reflect the following: (1) the adjusted life insurance reserves (described below) multiplied by the adjusted reserves rate (the lesser of an average rate for a 5-year period or the current earnings rate); (2) the mean of the pension plan

reserves at the beginning and end of the taxable year multiplied by the current earnings rate; plus (3) interest paid.

The taxable investment income for a life insurance company is the sum of the remaining portion of the investment yield (i.e., the company's share) and the net capital gain (long-term capital gain in excess of net short-term capital loss) reduced by the company's share of tax-exempt interest income, dividends received deductions, and a small business deduction (10 percent of investment yield up to a maximum deduction of $25,000).

Gain from operations

In determining gain from operations, there first is excluded the share of investment yield set aside for policyholders.

For this purpose, a formula different from that used for purposes of determining the company's taxable investment income is used. The share of investment yield that is excludable from gain from operations is determined by allocating the portion of each item of investment yield which reflects the percentage obtained by dividing the "required interest" by the investment yield.

The required interest is determined by multiplying the required or assumed rates of interest used by the company in calculating reserves for State insurance law purposes by the mean of the applicable reserve at the beginning and end of the taxable year. Generally, there are six categories of items taken into account as reserves related to insurance and annuity contracts.

A company's gain from operations is the sum of its share of investment yield, the amount of a net capital gain, and underwriting income (premiums, decreases in certain reserves, and all other items of gross income), reduced by specified deductions allowed.

Modified coinsurance

A life insurance company sometimes will insure itself against some policyholder risks it has undertaken. This type of insurance between insurance companies is referred to as "reinsurance". Modified coinsurance is a type of reinsurance agreement under which the company transferring some of its risks (the "ceding" company) retains ownership of the assets connected with the risks reinsured and also retains the reserve liabilities connected with the risks reinsured. The company which has agreed to assume the risks under the agreement (the "reinsurer") receives a premium which generally consists of both premium income and investment income attributable to the risks reinsured from the ceding company. Thereafter, periodic settlements are made between the companies for premiums collected, benefits paid, etc.

Code section 820 contains a rule which allows the ceding company and the reinsurer to report a modified coinsurance transaction for tax purposes as if the assets relating to the risks reinsured were transferred to the reinsurer, as if the premium income and the investment income on the assets were received directly by the reinsurer, and also as if reserves to reflect liability for future claims were maintained by the reinsurer. No transfer of assets or reserve liability actually occurs.

Section 820 was originally intended to avoid possible double taxation to both the ceding company and the reinsurer when a modified coinsurance agreement is used. However, some life insurance companies have used modified coinsurance to avoid or substantially reduce

income tax paid by both the reinsurer and the ceding company. For example, since a life insurance company cannot deduct policyholder dividends in excess of underwriting income (plus $250,000), it would benefit by converting investment income into underwriting income which then may be offset by excess policyholder dividends which would not otherwise be deductible. Similarly, a company with gain from operations exceeding its investment income, but without sufficient dividends to offset all underwriting income, could benefit by converting investment income into underwriting income because the tax on half of the underwriting income is deferred.

Any increased income to the reinsurer because of the deemed transfer of investment income could be offset by an "experience refund" to the ceding company equal to the investment income minus a minor "service charge." Moreover, a reinsurer may receive an additional benefit of sheltering its other underwriting income if it has elected the approximate method for revaluing reserves computed on a preliminary term basis, i.e., deductions for increases in reserves would exceed income attributable to the assets treated as transferred.

Thus, the effect of entering into a modified coinsurance agreement with a section 820 election has often been to convert taxable investment income into underwriting income on which a lesser or no tax is paid by the ceding company and to reduce gain from operations for the reinsurer.

Policyholder dividends

In addition to ordinary business deductions, special deductions are allowed in computing a life insurance company's gain from operations. The combined deductions for policyholder dividends, certain amounts attributable to nonparticipating contracts, and to accident and health and group life insurance contracts. are subject to a special limitation. Under the limitation, these deductions cannot exceed $250,000 plus the amount by which gain from operations (computed without regard to these deductions) exceeds taxable investment income.

Reserves

The concept of reserves is taken into account for several purposes under the life insurance company tax rules. The concept of life insurance reserves is relevant to the definition of a life insurance company which is subject to the special tax provisions; the concept of adjusted life insurance reserves is taken into account for purposes of determining the policyholders' share of investment yield which is excludable from taxable investment income; and increases and decreases in life insurance and other reserves are taken into account in determining gain or loss from operations.

"Menge" formula

A formula, commonly called the "Menge" formula, is used to compute the amount of adjusted life insurance reserves. Simply stated, the "Menge" formula is a mechanical arithmetic adjustment used to compute adjusted life insurance reserves. This computation will then be used in determining the policyholders' share of investment yield and accordingly affect the computation of a life insurance company's taxable investment income.

The formula operates to reduce life insurance reserves (other than pension reserves) by 10 percent for each percentage point by which

the adjusted reserves rate (the lower of the average earnings rate for a 5-year period or the current earnings rate) exceeds the interest rate assumed in calculating the reserves.

Revaluation of reserves

Present law permits taxpayers to revalue life insurance reserves computed on a preliminary term basis to a net level premium basis. This revaluation may be done under either an exact revaluation method or an approximate revaluation method. (Under the approximate revaluation method, reserves are generally increased by $21 per $1,000 insurance in force less 2.1 percent of reserves under such contracts. Reserves for term insurance are increased by $5 per $1,000 term insurance in force covering a period of more than 15 years, less 0.5 percent of reserves under such contracts.)

Consolidated returns

Two or more affiliated domestic life insurance companies may elect to file a consolidated return. Also, beginning in 1981, life insurance companies may be included in consolidated returns with non-life affiliated companies. For reporting purposes, some taxpayers have taken the position that taxable income first is determined for each component member of the affiliated group (e.g., taxable investment income for some companies and gain from operations for others) and then consolidated by adding those separate company taxable income bases. This approach is sometimes referred to as the "bottom line" method of consolidation.

The ruling position of the Internal Revenue Service, as taken in letter rulings, has been that the taxable investment income bases and the gain from operations bases first must be aggregated to arrive at consolidated group amounts and then these aggregate tax bases (taxable investment income and gain from operations) would apply for the consolidated group. This approach is sometimes referred to as a "phase-by-phase" method of consolidation.

Under regulations proposed on June 3, 1982, with respect to consolidation of non-life and life companies, a modified phase-by-phase method of consolidation would apply to a life insurance subgroup of companies. Consolidated amounts would be determined by aggregating separate amounts for each member in a life subgroup and a consolidated limitation would apply whenever a deduction is limited by an amount or percentage of an amount (including the 50-percent deferral for gain from operations in excess of taxable investment income and the limitation on policyholder dividends and special deductions). The proposed regulations would apply to the first taxable year for which the due date (without extensions) for filing a return is after the date final regulations are adopted. The proposed regulations would apply only in the limited context of consolidation of life insurance companies and non-life affiliates, but indicate a preference of the Internal Revenue Service for "phase-by-phase" consolidation over "bottom line" consolidation of life insurance companies.

Taxation of policyholders

Gross income includes any gain received as an annuity under an annuity, endowment, or life insurance contract. Amounts received before the annuity starting date are first considered to be nontaxable

returns of premiums and other consideration paid. Except for certain annuities under qualified pension plans, no special rules are provided with respect to the tax treatment of loans against an annuity contract or for withdrawals before either a specified time or attainment of a specified age.

Indeterminate premiums and excess interest

In recent years, many stock companies have begun to offer "indeterminate premium" policies under which the company charges a premium lower than the maximum premium fixed in the policy and "excess interest" policies under which the company credits interest at a rate in excess of the low, permanently guaranteed rate in the contract. Such lower premiums and higher interest rates are guaranteed to the policyholder on a temporary basis because the rate of interest companies can permanently guarantee in setting policy benefits is limited as a practical matter by State law (to as low as 4 to 5 percent in the case of life insurance reserves).

In computing their taxable income, these companies have included only the payments that they actually received under their indeterminate premium policies and have fully deducted, as additions to reserves to provide for guaranteed benefits, the amounts that they credited as excess interest. Recently, however, the Internal Revenue Service has suggested that the excess of the maximum premium chargeable over the premium actually collected may be income to these companies with the difference being deductible only as policyholder dividends. Also, the Internal Revenue Service has suggested that the excess interest may not be fully deductible by these stock companies by treating it as a policyholder dividend subject to the limitations previously described.

Administration Proposal

The provision of the Code that treats modified coinsurance arrangements as conventional coinsurance arrangements would be repealed. In addition, the proposal would clarify the treatment of experience refunds by providing for an allocation between investment and underwriting income. Also, the tax treatment of coinsurance arrangements would be revised to prevent disproportionate allocation of investment and underwriting income between the reinsured and the reinsurer.

These provisions generally would apply to all reinsurance arrangements entered into after 1981. The provisions relating to experience refunds and disproportionate allocations would apply after 1981 to all reinsurance arrangements.

Alternative Proposal of Life Insurance Industry

The American Council of Life Insurance (ACLI) has recommended the following alternative proposal.

Modified coinsurance

The proposal would suspend for two years (a "stopgap" period) the modified coinsurance rules for purposes of determining taxable investment income (generally affecting the ceding or reinsured company); continue modified coinsurance treatment for purposes of determining gain and loss from operations (generally benefiting the rein-

surer); and provide grandfathering protection for prior periods for certain modified coinsurance contracts (for taxable years beginning before 1982).

Policyholder dividend limitations

For a two-year stopgap period, companies would be given two alternative means of calculating the limitation for the policyholder dividend deduction and other special deductions.

The first alternative would incorporate the present limitation with only one change—the statutory dollar limit would be increased from $250,000 to $1 million.

The second alternative would provide a limitation determined as follows:

(a) 100 percent of the dividends attributable to insured qualified pension plans;

(b) a statutory amount of $1,000,000 (same as in the first alternative); and

(c) in the case of a mutual company, 80 percent of any remaining dividends or, in the case of a stock company, 87½ percent of any remaining dividends and the special deduction for nonparticipating contracts.

The 7½ percent differential is intended to reflect that a portion of the dividend distribution to mutual company policyholders constitutes a return of corporate earnings to them (deriving from their ownership interest in the company), and, accordingly, should not be deductible.

"Menge" formula

For a 2-year stopgap period, the 10-for-1 "Menge" formula would be revised to allow the policyholders' share of investment yield to be computed by using a geometric 10-for-1 formula to adjust statutory life reserves, and a 9.5 percent cap would be provided on the adjusted reserves rate that will be used.

Consolidated returns

For the 2-year stopgap period, the proposal would provide that consolidated life insurance company taxable income is determined by first computing the separate life insurance company taxable income for each affiliated company and then combining those amounts. Also, grandfathering protection would be provided for companies that have taken this reporting position for taxable years beginning before 1982.

Excess interest deductions

For taxable years beginning before 1982, the proposal would provide that amounts treated as interest deductions by a taxpayer on insurance or annuity contracts will be protected from reclassification as policyholder dividends on audit by the Internal Revenue Service.

Indeterminate premium policies

For taxable years beginning before 1982, the proposal would provide that amounts that could have been charged as a premium or mortality charge, but were not, are not to be included in income.

Other Proposals

Revaluing certain reserves

As recommended by a GAO report, the approximate revaluation method for revaluing life insurance reserves computed on a preliminary term basis could be revised for insurance (other than term insurance) so that reserves are increased by $15 per $1,000 insurance in force rather than by $21 per $1,000, and reduced by 1.5 percent of reserves rather than 2.1 percent. Alternatively, the approximate revaluation method could be repealed, so that the revaluation of reserves computed on a preliminary term basis would have to be computed under the exact revaluation method.

Certain annuity distributions

The following changes could be made in the treatment of distributions under an annuity contract prior to the annuity starting date:

(a) Distributions could be treated as first attributable to income credited to the contract and then attributable to return of premiums or other consideration paid.

(b) A loan against the contract could be treated as a distribution.

(c) A penalty similar to the 10-percent penalty imposed on early withdrawals from an individual retirement account could be imposed. For example, withdrawals within a certain period (such as 10 years after furnishing consideration for the contract), or prior to a certain age (such as 59½), could be subject to the penalty.

Excess interest and indeterminate premium policies

Statutory rules could be provided under which only amounts actually collected on indeterminate premium policies would be includible in gross income and excess interest would be fully deductible, rather than being subject to characterization as policyholder dividends.

Pros and Cons

Argument for the Administration proposal

Repeal of the modified coinsurance provisions (with other conforming changes) would eliminate permanently the unintended tax benefits derived from the provisions, e.g., the conversion of taxable investment income into underwriting gains on which little, if any, taxes are paid.

Arguments against the Administration proposal

1. The modified coinsurance provision should be considered as part of a package with some other needed changes in the insurance tax laws.

2. Until there is a comprehensive review of the life insurance company tax laws, there should only be a suspension of the modified coinsurance provisions, together with temporary changes of certain other provisions of the 1959 Act which are outdated, for an interim period during which the Congress could conduct the comprehensive review.

3. A simple repeal of the modified coinsurance provisions would increase the tax burden of certain members of the life insurance indus-

try too much. In addition, it would result in decreasing funds accumulated from the sale of life insurance policies that could be used as long term capital.

Arguments for the ACLI proposals

1. The stopgap proposals would raise a more appropriate amount of revenues from the life insurance industry, i.e., increasing revenues over present law with the present treatment of modified coinsurance, but providing some degree of tax relief from changed effects of certain provisions of the 1959 Act due to changed interest rates and different insurance products.

2. The ACLI proposals provide interim corrections during the two-year stopgap period (1982 and 1983) to permit a thorough Congressional review of the 1959 Act.

3. At a time of inflation and higher interest rates, the ACLI proposals relating to limitations on the policyholder dividend and other special deductions would carry out Congressional intent that investment income attributable to insured pension plans would be tax-free and permit the insurance industry to compete effectively for qualified pension plan business. Also, by allowing a minimum deduction of 80 percent for mutual companies and 87½ percent for stock companies, the proposals would (1) temporarily correct the problem arising when increases in taxable investment income attributable to high interest rates decrease the limitation on deductible policyholder dividends (the portion of the limitation based on operating gains in excess of taxable investment income); (2) generally restore the level at which policyholder dividends were deductible in 1959 (approximately 90 percent of policyholder dividends were deductible in 1959, but the portion has been approximately 60 percent recently); and (3) permit life insurance and annuity policies to remain competitively attractive by allowing companies to reflect better investment performance by higher dividends, lower premiums, or increased benefits. Finally, the ACLI proposals would take into account the effects of inflation since 1959 by increasing the minimum dollar limitation from $250,000 to $1 million and thereby restore the assistance to small companies intended in 1959.

4. The ACLI proposals would correct inaccuracies attributable to substantial increases in interest rates in recent years with respect to the 10-for-1 "Menge" formula used to revalue statutory reserves.

5. The ACLI proposals relating to consolidated returns would permit life insurance companies to file consolidated returns on a basis comparable to other taxpayers.

6. The grandfathering provisions for previous modified coinsurance arrangements, consolidated returns, excess interest, and indeterminate premium products would remove doubt about the tax treatment for such items for prior taxable years.

Arguments against the ACLI proposals

1. Because of the general acknowledgment that modified coinsurance has been abused, the modified coinsurance provisions should be repealed, rather than merely suspended for a two-year period (including repealing present treatment for reinsurers as well as for reinsured companies). If the present treatment of modified coinsurance were merely suspended, some unintended benefits could continue.

2. The proposals relating to provisions other than modified coinsurance should be considered within the context of a thorough review of the 1959 Act to develop permanent, rather than temporary, solutions.

3. Grandfathering protection for past modified coinsurance transactions sets an inappropriate precedent as a matter of tax policy and would unduly restrict the Revenue Service's authority to examine the substance of past transactions. If the transactions do not meet long-standing general requirements for favorable tax treatment, they should be challenged by the Revenue Service. Other grandfathering provisions would also set inappropriate precedents.

4. The proposals do not deal with all provisions that are not operating correctly because of changed circumstances since 1959, e.g., the approximate method for revaluing life insurance reserves computed on a preliminary term basis.

5. The minimum policyholder dividend deduction levels under the proposal would not sufficiently reflect the status of a policyholder of a mutual company as an owner-investor, i.e., amounts equivalent to nondeductible regular corporate dividends should not be deductible as policyholder dividends. Further, the proposal does not sufficiently reflect the tax deferral and exemption treatment available to policyholders on dividends credited to their policies.

6. The proposals relating to consolidated returns fail to reflect the general rule applicable to other taxpayers that dollar or percentage limitations should be determined on a consolidated basis.

7. Technical modifications to the proposals are necessary.

Arguments for other proposals

Revaluing certain reserves

1. As indicated by a GAO report, the approximate method for revaluing reserves for life insurance other than term insurance on a preliminary term basis ($21 per $1,000 insurance in force) should be revised because it produces reserves greater than what is actuarially needed. This is due to changed circumstances since 1959 (mortality, product and reserve method changes) and because many large established companies have obtained excessive allowances by electing the method which was originally intended to aid new and small companies.

2. The proposal to revise the approximate method for revaluing life insurance reserves on a preliminary term basis would remove an unintended benefit which now results in a substantial revenue loss.

3. The proposal is consistent with a package of changes to deal with circumstances which have changed since the 1959 Act was enacted.

Certain annuity distributions

The proposal relating to the tax treatment of annuity products would eliminate opportunities to use an investment in such products as a short-term tax deferral technique.

Excess interest and indeterminate premiums

1. The limit on policyholder dividends was originally intended to apply only to participating policies. Price reductions and interest payments guaranteed in advance for a reasonably long period of time to policyholders should not be characterized as policyholder dividends. Rather, they should be treated as excludable from income, in the case

of reductions in premiums, or as additional amounts credited to reserves, in the case of excess interest.

2. The tax benefits available to policyholders result from tax policies favoring provision for retirement and early death. The favorable policyholder tax treatment designed to achieve those tax policies should have no relevance in determining the appropriate taxable income base for insurance companies. In any event, the limit on policyholder dividends is a very inaccurate method for collecting a "proxy tax" on policyholders at the company level.

Arguments against other proposals

Revaluing certain reserves

1. The proposed revision of the approximate method of revaluing life insurance reserves on a preliminary term basis would increase the tax burden of the life insurance industry by too much.

2. Revision of the approximate method of revaluing life insurance would impact heavily upon smaller stock companies.

3. These proposals should be considered only in the context of a thorough review of the tax rules relating to life insurance taxation.

Certain annuity distributions

The proposals relating to annuities are not appropriate in the context of temporary stop-gap legislation because subsequent permanent changes could result in complex transitional rules for individual taxpayers.

Excess interest and indeterminate premiums

1. Allowing a full exclusion or deduction for these products fails to recognize the tax deferral and exemption available to policyholders.

2. Resolving the current uncertainty over tax treatment of these products in favor of the companies would give the products an inappropriate advantage over participating policies.

3. The 87½ percent minimum deduction provided in the ACLI proposal provides sufficient certainty pending resolution of the questions involved in the tax treatment of these products.

Revenue Effect

[Fiscal years, billions of dollars]

Item	1982	1983	1984	1985	1986	1987
Administration proposal	.9	2.5	2.4	2.6	2.7	2.9
ACLI proposal [1]	.5	1.4	.7			
Proposal to change formula for approximate reserve revaluation from $21 to $15 per $1,000 of reserves		.3	.5	.5	.5	.5
Annuity tax rules	(2)	(2)	(2)	(2)	(2)	(2)

[1] The proposal is only for a 2-year stopgap period.
[2] Not available at this time.

D. Construction Period Interest and Taxes

Present Law

Individuals, personal holding companies, and subchapter S corporations are required to capitalize interest and real property taxes attributable to the construction period of real property, other than low-income housing, that will be used in a trade or business or held for investment. The capitalized interest and taxes are amortized (i.e., deducted in equal portions) over a 10-year period. The interest that must be capitalized under this rule is interest which is attributable to the construction period for any debt incurred or continued for the purpose of acquiring, constructing, or carrying the real property. The construction period is defined as the period beginning on the date construction of the building or improvement begins and ending on the date the property is ready to be placed in service or is ready to be held for sale.

The amortization of capitalized interest and taxes begins in the year the interest or taxes are paid or accrued. However, the amortization of capitalized interest and taxes is then suspended until the year the building or improvement is ready to be placed in service, at which time the amortization resumes.

Corporations other than personal holding companies and subchapter S corporations are not subject to the capitalization requirement. For these corporations, interest and real property taxes are deductible for the year in which paid or accrued.

Administration Proposal

Corporations (other than personal holding companies and subchapter S corporations, which would continue to be subject to the present-law rules) would have to capitalize and amortize over 10 years interest and taxes attributable to the construction period of nonresidential real property. The amendment would be applicable to taxable years beginning after 1982.

Clarifying Proposal

The Administration proposal could be clarified to provide that interest with respect to indebtedness allocable to specific property could be allocated to such property, while all interest on remaining indebtedness could be allocated to remaining assets in proportion to certain expenditures.

Pros and Cons

Arguments for the proposal

1. Construction period interest and taxes, like other costs of construction, such as labor, materials, fees, and permits, may be viewed as costs incurred in acquiring property. Therefore, as in the case of these

other costs under present law, construction period interest and taxes should be capitalized and deducted only when the buildings are sold or used to produce income. The lack of restriction on these deductions under present law allows construction of an asset to create accounting losses which shelter other income from tax, since income and expenses are not properly matched.

2. Tax accounting rules requiring the deferral of costs of acquiring or producing property until the time the property is placed in service or sold generally apply equally to corporations and individual taxpayers. Insofar as these rules restrict the deduction of construction period interest and taxes, no policy reasons are apparent which justify limiting their application only to individual taxpayers.

3. By eliminating the disparate treatment of corporations and other taxpayers, the proposal would reduce the tax motives taken into account in determining whether to incorporate a business.

4. Unless this proposal is adopted, corporate taxpayers which construct their own assets would have an advantage over taxpayers which purchase assets from contractors subject to the proposed restrictions on the completed-contract method of accounting. These proposed restrictions would require contractors to cumulate ("capitalize") most construction costs, including construction period interest and taxes.

Arguments against the proposal

1. The present-law limitation on deducting construction period interest and taxes, applicable to individuals, restricts deductions of costs that can be used to produce accounting losses and shelter income from other sources. Such tax-shelter activities have been of greater concern to Congress when engaged in by individuals, personal holding companies, and subchapter S corporations rather than by larger corporations.

2. In view of the fungibility of money, it may be difficult to distinguish construction period interest from other interest.

3. Some taxpayers argue that ACRS results in a higher effective tax rate for real property than for personal property. The continued application of the capitalization rules, and the extension of those rules to corporations, would exacerbate any such bias against real estate investments.

4. Some corporations might cancel plans to construct property if the proposal were enacted, creating greater unemployment.

Revenue Effect

[Fiscal years, billions of dollars]

Item	1983	1984	1985	1986	1987
Administration proposal	.5	1.0	1.0	1.0	.9

E. Minimum Tax

Present Law

Corporate add-on tax

Corporations must pay a minimum tax on certain tax preferences in addition to the regular corporate income tax. The amount of the minimum tax is 15 percent of tax preferences in excess of the greater of the regular income tax paid or $10,000.

The tax preference items included in the minimum tax base for corporations are:

(1) Accelerated depreciation on real property in excess of straight-line depreciation over the useful life or recovery period (in the case of property eligible for ACRS, 15 years);

(2) Amortization of certified pollution control facilities (the excess of 60-month amortization over depreciation otherwise allowable);

(3) In the case of certain financial institutions, the excess of the bad debt deduction over the amount of that deduction computed on the basis of actual experience;

(4) Percentage depletion in excess of the adjusted basis of the property;

(5) 18/46 of the corporation's net capital gain; and

(6) Amortization of child care facilities (the excess of 60-month amortization over depreciation otherwise allowable).

In computing the amount of regular tax deductions from the minimum tax base, the corporation's regular tax liability is reduced by nonrefundable credits other than the ESOP credits. Credits (other than refundable credits) are not allowed against the corporate minimum tax.

The add-on minimum tax for corporations raises about $600 million per year.

Individual add-on tax

In the case of individuals, a similar add-on minimum tax applies, except that the items of tax preference also include (1) accelerated depreciation on personal property subject to a lease, and (2) intangible drilling costs on oil and gas wells in excess of the amount amortizable with respect to these costs, and in excess of net income from oil and gas production. Capital gains are not an item subject to the add-on tax for individuals. In the case of an individual, the add-on minimum tax is imposed on the amount of tax preferences in excess of the greater of one-half the regular income tax paid or $10,000.

In 1979, the add-on minimum tax for individuals raised $309 million.

Individual alternative tax

Individuals are also subject to an alternative minimum tax, which is payable to the extent it exceeds the regular tax paid. The alternative minimum tax is generally based on taxable income increased by (1)

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the deduction for long-term capital gains and (2) the amount of the taxpayer's adjusted itemized deductions.

Generally, adjusted itemized deductions are the amount of itemized deductions (other than for medical expenses, casualty losses, and State, local, and foreign taxes) in excess of 60 percent of adjusted gross income (reduced by the itemized deductions excluded above).

The tax rate is 10 percent of the alternative minimum taxable income from $20,000 to $60,000, and 20 percent of the amount in excess of $60,000. Tax credits, other than the foreign tax credit, are generally allowable only if attributable to an active trade or business and only to the extent the tax is not attributable to net capital gains or to adjusted itemized deductions. Any credit disallowed by this rule increases the amount allowed as a credit carryover.

The foreign tax credit is allowed in full. In general, the regular foreign tax credit rules apply, but the foreign tax credit limitation is computed separately. Thus, the amount of foreign tax that may be credited is limited to the same proportion of the gross alternative tax as the taxpayer's alternative minimum taxable income from sources without the U.S. bears to his entire alternative minimum taxable income. The taxpayer is then required to pay an amount equal to the greater of the after-credit regular tax or the after-credit alternative minimum tax. A special rule is also provided for computing the amount of unused foreign taxes that may be carried back or carried forward.

In 1979, the alternative minimum tax for individuals raised $8CC million.

Administration Proposal

Overview

The proposal would repeal the present law 15-percent add-on minimum tax for corporations (except for subchapter S corporations and personal holding companies) and establish a 15-percent alternative minimum tax. Under the proposal, a corporation would pay the alternative minimum tax only when it exceeds its regular income tax. The proposal would not amend the present law minimum tax provisions for individuals.

The new alternative minimum tax would apply to domestic corporations and foreign corporations engaged in a trade or business in the U.S. In general, the tax base would be a corporation's regular taxable income, increased by certain tax preference items for the year. Net operating loss deductions would not be allowed in computing the minimum tax base. The tax base then would be reduced by a $50,000 exemption and taxed at a 15-percent rate.

The foreign tax credit, but no other credits, would be allowed against the alternative minimum tax. The excess of the alternative minimum tax over the regular tax would be carried over as a credit to be applied against the regular tax in future years.

This description includes changes made by the Administration since the publication of the proposal in February, 1982.

Preferences

Existing tax preference items

Five preference items that would be added to taxable income in computing the alternative minimum tax base under the proposal would

be identical to tax preferences subject to the present law corporate minimum tax. The capital gains preference under the present corporate minimum tax would not have to be added separately to the tax base since the alternative minimum tax base automatically would include it as part of regular taxable income.

New tax preference items

In addition, the following items would be included as tax preferences:

(1) ***Intangible drilling costs.***—Deductions for intangible drilling and development costs of oil, gas, and geothermal wells (other than dry holes) in excess of the aggregate amount of deductions that would have been allowable for the year had the IDC's on all such wells drilled after 1982 been capitalized and amortized on a straight line basis over 10 years. There would be no offset for the net income from oil and gas production for the year.

(2) ***Mining exploration and development costs.***—Deductions for mining exploration and development costs in excess of the amortization that would have been allowable on a straight line basis over 10 years.

(3) ***Lessor safe-harbor leasing benefits.***—Benefits attributable to safe harbor leases under ACRS. The amount of the preference for each lessor (buyer of tax benefits) would be the excess of (1) the current year's ACRS deduction minus the excess of the rental income over the interest deductions with respect to the lease for the taxable year (i.e., the net deductions received by the lessor as a result of the safe-harbor sale-leaseback transaction) over (2) the initial amount of cash investment by the lessor amortized over the lease term. Leases entered into before February 26, 1982, would be exempted.

(4) ***Deductions for debt to carry tax-exempt securities.***—Interest on indebtedness to purchase or carry tax-exempt securities purchased after 1982, to the extent deducted under current law.

(5) ***Deferred DISC income.***—A corporate shareholder's pro rata share of DISC income for the year that is not taxed currently.

(6) ***Deferred shipping income.***—The net increase for the taxable year in the income and capital gains accounts under capital construction funds under the Merchant Marine Act.

(7) ***Amortization of motor carrier operating rights.***—All deductions claimed under the 5-year amortization provisions added by ERTA for motor carrier operating authorities, many of which diminished in value as a result of the deregulation of motor carriers on July 1, 1980.

(8) ***Excess OID interest.***—Interest deductible on original issue discount (OID) bonds in excess of the amount that would be deductible were the OID amortized according to a method which yields the same pattern of deductions that would result from borrowing the same amount of money with par-value bonds having the same yield to maturity. (For OID bonds issued after May 3, 1982, the Treasury Department proposes to require that deductions be computed with this method under the regular tax. See item H below.)

(9) ***Deductions for costs incurred for long term contracts.***—Current deductions of certain indirect costs incurred for long-term contracts entered into on or before February 26, 1982. The amount of the preference would be the excess of those deductions over the deduc-

tions that would have been allowable if those costs were capitalized and deducted under the proposed progress payment method of accounting for long-term contracts. The indirect costs subject to this rule are those costs that would have to be allocated to long-term contracts subject to the proposed progress payment method of accounting were the contract entered into after February 26, 1982.

Net operating losses

Net operating loss (NOL) carryovers and carrybacks would not be allowable as deductions in computing the minimum tax base. The amount of any NOL carryover or carryback allowable in computing the regular tax would be treated as absorbed, even for years in which the corporation pays the alternative minimum tax.

Foreign tax credit

The foreign tax credit allowed against the alternative minimum tax would be computed in a mannner similar to the way foreign tax credit is presently computed when it is allowed against the alternative minimum tax for individuals. In general, the amount of foreign income taxes paid or accrued that could offset the minimum tax could not exceed the portion of the tax attributable to foreign source minimum taxable income. The present limitations for foreign oil income (sec. 907) would apply. Foreign taxes in excess of the current year's limitation could not be carried over to be used against the minimum tax in other years.

Other regular tax credits

No other credits would be allowed. The amount of any unused credit carryover or carryback allowable in computing the regular tax would be treated as absorbed, even for years in which the corporation pays the alternative minimum tax.

Minimum tax credit

The proposal would establish a minimum tax credit equal to the excess of the alternative minimum tax liability over the regular tax liability computed for that year. The credit would be applied as a carryover against the regular tax in subsequent years. The carryover period would be 15 years.

Effective date

The new minimum tax provisions for corporations would apply for taxable years beginning after 1982.

Alternative Proposals

1. The Administration's minimum tax proposal could be modified to allow loss carryovers resulting from real economic losses to be deducted in computing the minimum tax base, to allow a partial investment tax credit in computing the minimum tax, and to make sure the minimum tax more accurately reflects economic income.

2. The present alternative minimum tax for individuals could be expanded by enlarging the list of tax preferences subject to that tax. There could also be an increase in the $20,000 exemption.

3. In place of an alternative minimum tax for corporations, there could be a direct reduction in tax preferences for both corporations and individuals of, for example, 15 percent of each preference. This could apply to the same items of tax preference which the Administration proposes to include in its minimum tax. This could replace the present add-on minimum tax or, alternatively, could be in addition to such tax.

4. In place of an alternative minimum tax, a temporary (e.g., 3-year) low rate tax (2 to 4 percent) could be imposed on a broad income base with a deduction allowed for regular corporate income taxes paid and an exemption of, for example, $100,000 to exclude small businesses from the tax. One possible tax base would be an adjusted taxable income base with deductions allowed for U.S. and foreign taxes paid. The adjustments made to taxable income to compute the tax base could include adding back certain preferences and tax benefits purchased in safe-harbor leasing transactions, and subtracting 18/46ths of long-term capital gains. An alternative approach would be to use income as determined for financial accounting purposes (i.e., book income). Another possible tax base would be earnings and profits. Book income and earnings and profits include tax-exempt interest and capital gains and limit ACRS deductions.

Pros and Cons

Arguments for the proposals

1. Every corporation and individual whose economic income exceeds a certain amount should be required to pay the government at least a minimum amount of tax on that income.

2. Broadening the base of corporate and individual taxes would accord with recent efforts to reduce the economic distortions induced by high marginal rates.

3. Taxing corporations on financial income would conform tax income to income computed in the marketplace, thus substituting a measure of income which more accurately reflects economic income.

4. Using a book income base to compute minimum tax liability would create a desirable conformity between financial accounting and tax accounting, similar to that already required in certain respects (e.g., LIFO).

Arguments against the proposals

1. The proposals would reduce the investment incentives which the Congress has enacted.

2. An alternative minimum tax may lead to an incentive to merge companies with large tax preferences with those with large taxable income.

3. A tax which is more a surtax in nature, rather than being imposed on a broad, economic income base, would aggravate the disparities between corporations with high and low effective tax rates.

4. The proposals would add complexity to the law.

5. The tax preferences which would be subject to the minimum tax were generally enacted into law in order to accomplish some social or economic purpose. These goals would be undermined by a minimum tax.

Revenue Effect [1]

[Fiscal years, billions of dollars]

Item	1983	1984	1985	1986	1987
Administration proposal	2.3	4.8	4.5	3.7	3.8

[1] Figures reflect Administration estimate and do not take into account changes in the proposal since February, 1982.

F. Accelerated Corporate Income Tax Payments

Present Law

Rules applicable to corporations generally

Estimated tax.—Under present law, a corporation generally must make payments of its estimated tax liability for the taxable year. The estimated tax is payable in up to four installments over the taxable year.

In general, if estimated tax payments are not equal to at least 80 percent of the tax due, a nondeductible penalty equal to the interest that would accrue on the unpaid tax is imposed on the amount by which the payment is less than 80 percent of the tax due. However, the underpayment penalty does not apply if, before the due date of any installment, the corporation pays an installment based on:

(1) the corporation's tax liability for the prior year,

(2) the corporation's tax liability on the prior year's income computed using tax rates for the current year, or

(3) 80 percent of the tax which would be due if the corporation's annual income were equal to the amount which would result if the corporation continued to receive income during the remainder of the year at the same rate experienced up to the date of the installment (i.e., the corporation's income computed on an annualized basis).

Final payment of tax.—As a general rule, a corporation's final tax payment is due with its income tax return 2½ months after the end of the corporation's taxable year. However, the corporation may elect to pay only half of the unpaid tax on this date and the second half three months later.

Refunds of overpaid tax generally are not made until after an income tax return is filed. However, quick refunds may be requested immediately after the close of the taxable year if the overpayment exceeds $500 and 10 percent of expected tax liability. Tax returns are due 2½ months after the end of the taxable year, but the Internal Revenue Service may grant a six-month extension of this date.

Special rules applicable to large corporations

In general, large corporations (i.e., those with taxable income of $1 million or more during any of the three preceding taxable years) are subject to the same rules on payment of income tax as are smaller corporations. Under present law, however, for 1984 and thereafter, a large corporation will not be able to use the first two exceptions above in order to avoid the underpayment penalties. For 1982 and 1983, large corporations will be able to use the first two exceptions only if their estimated tax payments equal at least 65 percent (in 1982) or 75 percent (in 1983) of the current year's tax liability.

Administration Proposals

1. The amount of estimated tax payments required for all corporations to avoid underpayment penalties would be increased from 80 percent to 90 percent of current year's tax liability for 1983 and thereafter. A corresponding change would be made in the third exception, above.

2. The full amount of unpaid tax would be due 2½ months after the end of the taxable year.

3. For 1984 and 1985, the first two exceptions to the underpayment penalty (estimated payments based on prior year's tax liability or income) would be available to large corporations only if estimated tax payments were at least 80 and 85 percent of tax due, respectively. These exceptions would not be available to large corporations after 1985. Thus, after 1985, to avoid underpayment penalties, large corporations would be required to pay at least 90 percent of their current tax liability through estimated payments unless the third exception is applicable.

Alternative Proposal

Some or all of the increase in the amount of penalty attributable to the above proposals could be imposed as a deductible interest charge.

Pros and Cons

Arguments for the proposals

1. Corporations may defer paying a significant portion of their income tax liability until after the end of the taxable year. Thus, they may obtain the equivalent of an interest-free loan from the Treasury, which is required to borrow this amount at market interest rates. Although the same requirements for prepayment of tax and exceptions from underpayment penalties generally apply to individuals, most individuals prepay more than 100 percent of their tax through withholding.

2. Corporations have ready access to professional tax assistance, can estimate their income accurately, and thus can determine their tax liability as installments are due. Once determined, there is no justification for not paying the tax.

Arguments against the proposals

1. In computing the tax liability of a large corporation, there are numerous issues of law and fact that can affect tax liability. The 90-percent requirement would demand greater precision than is possible under these circumstances.

2. Overpayments are likely to be increased if larger amounts of tax must be prepaid, since deductions and tax credits accrued or business conditions occurring late in the year could reduce the corporation's tax liability below the prepaid amount. Since refunds of overpayments generally are not made until several weeks after a tax return is filed, the overpayment might not be refunded for almost a year after the close of the corporation's taxable year. (The return would be filed 8½ months after the close of the taxable year if an extension of time to file were granted.)

Revenue Effect

[Fiscal years, billions of dollars]

Item	1983	1984	1985	1986	1987
Administration proposals	1.2	1.1	1.2	.4	.1

G. Business Energy Tax Incentives

Present Law

Energy tax credits

Business energy tax credits are available for qualified investments in specified energy property. The amount of the credit depends upon the type of property acquired and the acquisition date.

Generally, the credit for energy property investments is 10 percent and expires after 1982; however, an affirmative commitment rule extends the credits until 1990 for certain long-term projects. In addition, the energy credit is available through 1985 for investments in (1) solar, wind, and geothermal property (a 15-percent rate), (2) ocean thermal property (a 15-percent rate), (3) qualified hydroelectric generating property (an 11-percent rate), (4) qualified intercity buses (a 10-percent rate), and (5) biomass property (a 10-percent rate).

Production tax credit

A production tax credit of up to $3 per barrel of oil equivalent (adjusted for post-1979 inflation) is provided for the production of qualified fuels including oil from shale and sands, gas from unconventional sources, synthetic fuels from coal, certain processed wood fuels, and steam from agricultural by-products. The production credit generally is subject to a phase-out as domestic oil prices approach $29.50 per barrel adjusted for post-1979 inflation ($35.10 per barrel for calendar year 1981) and expires in 2001.

Industrial development bonds (IDBs)

Present law permits tax-exempt IDB financing for certain small-scale hydroelectric facilities owned by municipalities, certain facilities to produce steam or alcohol from solid waste, and certain State energy conservation programs.

Alcohol fuels exemption and tax credit

Gasohol which contains at least 10 percent alcohol is exempt (through 1992) from the 4-cent-per-gallon excise tax on motor fuels. Alternatively, alcohol used in fuels is eligible for a tax credit (through 1992) of up to 40 cents per gallon.

Administration Proposal

All of the above business energy tax incentives would be repealed as of December 31, 1982, and the existing affirmative commitment rule applying to credits which expire in 1982 under present law would be modified. However, transition rules would apply to these changes.

The transition rules would be as follows:

a. The repeals would not apply if a binding contract for the acquisition of eligible property was entered into before February 26, 1982.

b. For self-constructed property and progress expenditure property (projects with construction periods of at least two years), the credits would apply for 1982 expenditures even though the property is placed in service after 1982.

c. Taxpayers signing binding contracts before January 1, 1983, to acquire or construct long-term projects would be eligible for credits until December 31, 1985. In addition, this rule would replace the present affirmative commitment rule which applies to property for which the energy credit presently expires after 1982.

d. Alcohol fuel producers would be eligible for a production credit through 1988 for capacity either in place or for which a binding contract had been signed by February 26, 1982. For production from this capacity, the credit would be at the present-law rate through 1985 and would phase out by 10 cents per year thereafter.

Pros and Cons

Arguments for the proposal

1. The need for these special incentives has been substantially eliminated by the decontrol of oil prices, the gradual deregulation of natural gas, and generally higher energy prices.

2. These incentives were enacted prior to adoption of ERTA. The liberalization of depreciation and the regular investment credit in ERTA provides adequate incentives to capital investment without these energy credits.

3. If Federal support is to be given to synfuels and conservation expenditures, that decision should be made directly by the Congress through the authorization and appropriations processes.

4. The availability of these incentives for only a few alternative energy sources diverts capital and technology away from conservation expenditures and other alternative energy sources which may be less expensive ways of reducing oil and gas consumption.

Arguments against the proposal

1. Reducing oil imports would have benefits, including improved national security and lower prices for imported oil, which are not taken into account by consumers in deciding whether to switch to alternative energy sources. Thus, it is necessary for the government to provide extra incentives for the production of these sources.

2. These incentives were designed to encourage development of new forms of energy production by providing incentives for early development of pilot projects. Since the provisions which would be repealed were enacted in their present form only in 1980, there has not been adequate time to prove the financial merit of these new technologies.

3. The recent slump in oil prices has jeopardized many energy projects. Repeal of these incentives would further delay development of technologies and construction of facilities that are needed to reduce our dependence on fossil fuels.

4. Some taxpayers have planned their investments for 1983 and later in reliance on these energy incentives. Repeal would force them to delay investments and incur expenses in restructuring their activities.

Revenue Effect

[Fiscal years, billions of dollars]

1983	1984	1985	1986	1987
.1	.3	.5	.5	.5

H. Amortization of Original Issue Discount on Bonds

Present Law

Tax treatment of corporate original issue discount bonds

Normally, a bond is issued at a price approximately equal to the amount for which the bond will be redeemed at maturity, and the return to the holder of the bond is entirely in the form of periodic interest payments. However, in the case of original issue discount (OID) bonds, the issue price is below the redemption price, and the holder receives some or all of his return in the form of price appreciation. The gap between the issue price and redemption price is the original issue discount. The extreme case of an OID bond is a zero-coupon bond, in which there are no periodic interest payments, and the holder's entire return comes from price appreciation.

Under present tax law, for bonds issued by a corporation the original issue discount is treated as accruing in equal installments over the life of the bond. Thus, an issuer of an OID bond deducts, as interest, both any periodic interest payments and a ratable portion of the original issue discount each year, and the holder of the bond includes this same amount in income. For example, if a corporation issues a $1,000 25-year bond paying a $70 annual coupon for an issue price of $500, it would deduct $90 each year over the life of the bond ($70 annual coupon plus 1/25th of the $500 original issue discount). The holder of the bond would also report $90 of income each year.

Example comparing corporate OID and ordinary bonds

Assume a 15-percent interest rate. Suppose a business wants to borrow $1 and then borrow at the end of the year to pay all interest charges for the year, and repeat this sequence each year for 30 years. Its interest payments would be 15 cents in the first year, 17.3 cents the second year (15 percent interest on the outstanding balance of $1.15), and so on, and would grow exponentially, eventually equaling $8.64 in the 30th year. At the end of 30 years, the overall debt would mount up to $66.21. A total of $65.21 in interest would be paid, and deducted, over the period, but the deductions would start small and grow.

The taxpayer could achieve the same substantive result by issuing a zero-coupon bond at a price of $1 redeemable for $66 in 30 years. However, by using the OID bond, the taxpayer can obtain a deduction of $2.17 each year ($65 divided by 30). Thus, the OID bond allows larger interest deductions in early years than borrowing the same amount with ordinary loans. Conversely, the purchaser of the OID bond includes more interest in his income in early years than the purchaser of an ordinary bond.

Table 1 shows the different patterns of deductions for the issuer and income inclusion for the holder between a zero-coupon bond and borrowing with ordinary loans under present law.

TABLE 1.—COMPARISON OF INTEREST DEDUCTIONS AND INCOME INCLUSION BETWEEN BORROWING $1 WITH ZERO-COUPON BONDS AND WITH ORDINARY LOANS UNDER PRESENT LAW

[Dollars]

Year	Ordinary loans	Zero-coupon bond	Difference
1982	0.150	2.174	2.024
1983	0.173	2.174	2.001
1984	0.198	2.174	1.976
1985	0.228	2.174	1.946
1986	0.262	2.174	1.912
1987	0.302	2.174	1.872
1988	0.347	2.174	1.827
1989	0.399	2.174	1.775
1990	0.459	2.174	1.715
1991	0.528	2.174	1.646
1992	0.607	2.174	1.567
1993	0.698	2.174	1.476
1994	0.803	2.174	1.371
1995	0.923	2.174	1.251
1996	1.061	2.174	1.113
1997	1.221	2.174	0.953
1998	1.404	2.174	0.770
1999	1.614	2.174	0.560
2000	1.856	2.174	0.318
2001	2.135	2.174	0.039
2002	2.455	2.174	−0.281
2003	2.823	2.174	−0.649
2004	3.247	2.174	−1.073
2005	3.734	2.174	−1.560
2006	4.294	2.174	−2.120
2007	4.938	2.174	−2.764
2008	5.679	2.174	−3.505
2009	6.530	2.174	−4.356
2010	7.510	2.174	−5.336
2011	8.636	2.174	−6.462
Total	65.212	65.212	0
Present value (computed at 8.1 percent after-tax rate)	11.738	24.245	12.505

Assumptions

Ordinary bond: Taxpayer borrows $1 in 1981 and borrows every year to pay the interest on the outstanding indebtedness. Interest rates remain at 15 percent. All debt repaid in 2011.

Zero-coupon bond: Taxpayer issues bond for price of $1 with no coupon, maturing in 30 years at a price of $66.21 (15-percent yield to maturity).

Treatment of noncorporate OID bonds

In the case of noncorporate OID bonds, the treatment of the issuer is the same as for corporate OID bonds for accrual-basis taxpayers. However, the cash-basis holder of the noncorporate bond defers inclusion of the OID in taxable income until the bond is sold or redeemed.

Administration Proposal

Amortization of original issue discount for purposes of computing both the interest deduction of the issuer and the income inclusion of the holder would be computed using a formula that parallels the manner in which interest would accrue through borrowing with ordinary bonds. (This is how OID bonds are treated in corporate financial statements.) The difference between the new rules and present law can be seen by comparing the two columns of table 1. The new rules would apply to bonds issued after May 3, 1982, except where a written binding commitment was made prior to May 4, 1982.

Also, noncorporate OID bonds issued after June 9, 1982, would be treated like corporate OID bonds, with exceptions for U.S. government savings bonds, tax-exempt State and local government bonds, Treasury bills and bonds issued by individuals.

May 3, 1982, and June 9, 1982, were the dates of the Treasury press releases announcing Treasury's intention to seek legislation in these areas.

Pros and Cons

Arguments for the proposal

1. The larger deductions allowed to issuers of OID bonds in the early years of a bond's term relative to deductions allowed issuers of ordinary bonds is a substantial tax advantage to the former, an advantage that increases with the term of the bonds. There is no justification for providing a tax incentive for issuing long-term OID bonds.

2. The larger income inclusion for OID bond purchasers in early years relative to purchasers of ordinary bonds unjustifiably penalizes those who wish to take advantage of the opportunity the OID bond provides to guarantee the reinvestment of the interest payments at the bond's initial yield to maturity. Under present law, only tax-exempt borrowers, such as pension funds, can avoid this penalty.

3. There is no reason to treat holders of corporate OID bonds more harshly than holders of noncorporate OID bonds.

Argument against the proposal

A tax incentive for long-term borrowing is necessary to encourage corporations to reduce their large amounts of risky short-term borrowing.

Revenue Effect

[Fiscal years, billions of dollars]

1983	1984	1985	1986	1987
.2	.2	.4	.5	.6

I. Stripping of Interest Coupons from Bonds

Present Law

A purchaser of a bond or other debt instrument with coupons attached may strip the unmatured interest coupons from the bond and dispose of either the stripped interest coupons or the corpus of the bond (i.e., the right to receive the principal amounts of the bond at maturity), or both the coupons and the corpus in separate transactions. Most such transactions involve U.S. government or agency obligations, but they may also involve tax-exempt obligations or taxable bonds issued by the private sector.

It is arguable that all of the taxpayer's basis in the debt instrument is allocated to the corpus, in which case a taxpayer who sells the corpus and retains the coupons may claim a loss on the sale of the stripped corpus equal to the difference between the amount for which he bought the debt instrument (with coupons attached) and the amount received for the corpus (without coupons). The loss, if allowable, would generally be an ordinary loss if the taxpayer is a dealer in such obligations or a bank. Otherwise, any loss allowable would be a capital loss.

For the person who buys the stripped bond, gain on any later sale, or on redemption of the stripped bond, is ordinary income to the extent of the difference between what would have been the value of the obligation with coupons attached at the time of its purchase and the actual cost of acquisition. For the purchaser of detached coupons, the coupons are a capital asset. Gain on their sale may be treated as a capital gain. However, if the coupons are redeemed, the purchaser of the coupons has ordinary income equal to the difference between the amount received on redemption of each coupon and the purchase price allocable to that coupon.

For example, assume that a broker-dealer sells a $100,000 U.S. Government 20-year coupon bond with coupons detached for $8,000 immediately after the bond is issued. The $92,000 may constitute an ordinary loss to the seller. Also, the buyer of the stripped bond who holds it until maturity will report no income until maturity, when he or she will report $92,000 of ordinary income. Thus, there is a tax deferral on $92,000 of income.

There is also a tax benefit to a purchaser of detached, unmatured interest coupons. In substance, each coupon is like an original issue discount bond, which should be subject to periodic inclusion rules (see item H above). Under present law, income is deferred until the coupon is sold or redeemed.

Administration Proposal

Under this proposal, the taxpayer who strips coupons from a bond and disposes of either the bond or the unmatured, detached coupons would be required to allocate the basis of the obligation (with coupons attached) between the retained portion and the portion disposed of in

accordance with their respective fair market values. This rule would prevent an artificial loss on the sale of a stripped bond.

When either a stripped bond or detached, unmatured coupons are purchased, the purchaser would be treated as having acquired an original issue discount bond with a discount equal to the excess of the redemption price of the bond (or amount payable on the coupon) over the purchase price of the stripped bond (or detached coupon). Thus, discount income would be attributed to the stripped bond or detached coupon and taxed to the purchaser between the purchase date and the date of maturity (or due date of the coupon) under the inclusion rules for original issue discount.

The taxpayer who strips and disposes of either the bond or the coupons would be subject to the periodic OID inclusion rules with respect to the retained portions, just as if he had purchased each of them for the amount of basis allocated to each retained portion.

The proposals would apply to transactions occurring after June 9, 1982, the date of the Treasury press release announcing its intention to propose legislation on coupon stripping.

Pros and Cons

Arguments for the proposal

1. Coupon stripping may permit income tax deferral through an artificial loss from selling the stripped bond, analogous to the deferral formerly accomplished through straddles that was eliminated by ERTA. Deferral through coupon stripping should be subject to the same policy that eliminated deferral through straddles.

2. Allocating the entire cost of an obligation with interest coupons to the corpus when a stripped bond or interest coupons are disposed of is economically unrealistic.

3. Upon disposition of the stripped bond or the detached, unmatured coupons, both the retained portion and the portion disposed of represent the right to a fixed amount payable at a future date that is purchased at a discount. The periodic OID inclusion rules applicable to obligations issued at a discount provide the appropriate tax treatment.

Argument against the proposal

The proposed rules would be somewhat more complicated than current law for persons desiring to purchase stripped bonds and unmatured interest coupons.

Revenue Effect

[Fiscal years, billions of dollars]

1983	1984	1985	1986	1987
([1])	.1	.1	.1	.2

[1] Increase of less than $50 million.

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J. Medicare Tax on Federal Employees

Present Law

The Federal Insurance Contributions Act (FICA) imposes two employment taxes on employers and employees—a "social security" tax and a "hospital insurance" tax. The two FICA taxes are imposed on wages paid for employment, and both taxes are imposed at rates which are the same for both employer and employee. The amount of wages taxable for a calendar year is subject to a limit ($32,400 for 1982 which is adjusted each year to reflect the increase in average wage levels.

Revenues from the hospital insurance FICA tax are deposited into the Hospital Insurance Trust Fund and finance the costs of hospital and related post-hospital services (Part A of Medicare) incurred by beneficiaries as provided for in the Social Security Act. This tax is imposed at the rate of 1.3 percent of wages received from employment during the calendar years 1982–1984, 1.35 percent of wages received during 1985, and 1.45 percent of wages received after December 31, 1985.

Entitlement to Part A Medicare benefits for the vast majority of workers currently reaching age 65 is based on eligibility for monthly retirement or survivor benefits under social security or the railroad retirement system. Entitlement also applies to certain disabled workers under age 65 and certain workers with end-stage renal disease.

In general, wages from all kinds of employment are subject to FICA taxes. However, certain types of employment or trades or businesses are exempt from social security coverage. Wages paid to individuals employed by the United States or any instrumentality of the United States, other than members of the uniformed services, are generally exempt from FICA taxes if (1) the employment comes under a retirement system established by a law of the United States, (2) the service is performed for certain U.S. instrumentalities that were exempt from tax in 1950 and that have established a retirement system, or (3) the service is performed by certain individuals or groups.

Administration Proposal

Beginning in 1983, Federal employees would begin paying the Hospital Insurance (HI) portion of FICA taxes. Federal employees who reach age 65, suffer from end-stage renal disease, or become disabled would earn coverage for, and become entitled to, Medicare after paying taxes for the same number of years (usually 10) as is required of other employees. Federal employees would not earn coverage for social security cash benefits through payment of this HI tax, but may, as at present, earn such coverage through another source of employment.

The Administration proposal includes a transitional provision for Federal employees who are age 56 or above on January 1, 1983, and

who otherwise may not earn coverage sufficient to qualify for Medicare at age 65. This provision would require these employees to work and pay the HI tax each year beginning in 1983 but only up to age 65. Federal employees who become disabled would be required to meet the same disability criteria imposed on applicants for social security disability cash benefits. Spouses of Federal employees would be covered for the hospital insurance part of Medicare under the normal criteria contained in title II of the Social Security Act: a spouse who is over age 65 would be entitled to HI based on the Federal employee's coverage status.

Pros and Cons

Arguments for the proposal

1. Approximately 80 percent of retired Federal workers aged 65 or older are already covered by medicare because of other employment during their working lives covered by social security, or because of their status as a spouse of a covered worker. Yet, these workers pay much less into the medicare trust fund than other medicare beneficiaries, who typically contribute to the trust fund during their entire working lives.

2. The proposal would increase the income of the HI Trust Fund.

Argument against the proposal

1. Take-home pay of Federal workers has been adversely affected by limitations on pay raises and dramatic increases in health plan premiums. Under these circumstances, it would be unfair to adopt another policy reducing their take-home pay. The reduction in take-home pay would also interfere with the Federal Government's ability to attract qualified workers.

Revenue Effect

[Fiscal years, billions of dollars]

1983	1984	1985	1986	1987
.6	.8	.9	1.1	1.3

Note.—Medicare trust fund receipts would be increased by double these amounts because the Federal Government would make a matching employer contribution which would not affect unified budget receipts.

K. Airport and Airway Trust Fund Taxes

Present and Prior Law

Present law

Since October 1, 1980, when certain aviation excise taxes either expired or were reduced and the transfer of aviation excise tax revenues to the Airport and Airway Trust Fund ceased, a tax on air passenger tickets has been imposed at the pre-trust fund rate of 5 percent, and the revenues have been going into the general fund. In addition, there is a 4-cents-per-gallon tax on noncommercial (general) aviation gasoline and taxes on aircraft tires and tubes, the revenues of which currently go into the Highway Trust Fund.

Currently, there are no aviation excise taxes on air freight, international departures, nongasoline aviation fuels, or aircraft use.

Prior law

During the period from July 1, 1970 through September 30, 1980, the Airport and Airway Trust Fund was financed by the receipts from several aviation excise taxes. The tax on domestic air passenger tickets was 8 percent; the tax on air freight was 5 percent; the international departure tax was $3 per person; and the fuels tax for noncommercial aviation was 7 cents per gallon (for gasoline and nongasoline). Also, there was an annual aircraft use tax, and there were taxes on aircraft tires and tubes.

Administration Proposal

Under the Administration proposal, the Airport and Airway Trust Fund excise taxes would be reinstated generally at the prior law levels, except that fuels tax rates for noncommercial aviation would be higher than prior law levels.

Effective July 1, 1982, the Administration proposal would make the following permanent changes: increase the air passenger ticket tax from 5 percent to 8 percent; reinstate the 5-percent air freight waybill and $3 international departure taxes; and increase the fuels taxes for noncommercial aviation to 12 cents per gallon for gasoline and 14 cents per gallon for nongasoline (e.g., jet) fuels. Further, the fuels tax rates would each increase by 2 cents per gallon on October 1, in 1983 and each of the following three years, until reaching 20 cents per gallon for gasoline and 22 cents per gallon for nongasoline fuels in fiscal year 1987 and thereafter. The prior law aircraft use tax would not be reinstated.

Revenues from these aviation excise taxes and the existing taxes on aircraft tires and tubes would be transferred to the Airport and Airway Trust Fund beginning on July 1, 1982.

Alternative Proposal

Ways and Means Committee bill (H.R. 4800)

As reported, H.R. 4800 would extend and reinstate the aviation excise taxes and would transfer revenues from those taxes to the Airport and Airway Trust Fund, during the period from July 1, 1982 through December 31, 1983. Trust Fund revenues would be available for the purposes specified in H.R. 2643, as reported by the House Committee on Public Works and Transportation. (H.R. 4800 is intended to be offered on the House floor by the Ways and Means Committee as the revenue title to H.R. 2643.)

Under H.R. 4800, the air passenger ticket tax would continue at its present 5-percent rate and the air freight waybill tax would be reinstated at its prior rate of 5 percent. The international departure tax would be reinstated at a rate of $5 per person. The fuels tax for noncommercial (general) aviation would be imposed at 12 cents per gallon for both gasoline and jet fuel and the aircraft tire and tube taxes would continue as under present law. The prior law aircraft use tax would not be reinstated.

(Table 2 following gives a comparison of aviation excise taxes and rates under present and prior law, H.R. 4800, and the Administration proposal.)

TABLE 2.—COMPARISON OF AVIATION EXCISE TAXES UNDER PRESENT AND PRIOR LAW, H.R. 4800, AND ADMINISTRATION PROPOSAL

Tax	Present law rates	Prior trust fund rates (July 1970 to Sept. 1980)	H.R. 4800—Ways and Means bill [1]	Administration proposal [2]
Air passenger ticket tax	5 percent	8 percent	5 percent	8 percent.
Air freight waybill tax	None	5 percent	5 percent	5 percent.
International departure tax	None	$3/person	$5/person	$3/person.
Fuels tax for noncommercial (general) aviation:				
Gasoline	4 cents/gal	7 cents/gal	12 cents/gal	12 to 20 cents/gal.[3]
Nongasoline (jet fuel, etc.)	None	7 cents/gal	12 cents/gal	14 to 22 cents/gal.[3]
Aircraft use tax	None	[4]	None	None.
Aircraft tires and tubes taxes	[5]	[5]	[5]	[5]

[1] Except for the 5-percent ticket tax (which is a continuation of present law), the tax rates under H.R. 4800 would apply from July 1, 1982 through December 31, 1983. Transfers of aviation tax revenues to the trust fund would apply to revenues received from July 1, 1982-December 31, 1983.

[2] The new tax rates and transfers to the Airport and Airway Trust Fund would be effective on July 1, 1982 (with no expiration date).

[3] The gasoline tax rate would be 12 cents/gallon for fiscal years 1982 and 1983, increasing by 2 cents/gallon annually to 20 cents in fiscal year 1987 and thereafter. For non-gasoline, the tax rate would be 14 cents/gallon in 1982 and 1983, increasing 2 cents/gallon annually to 22 cents in fiscal year 1987 and thereafter.

[4] An annual use tax of two parts: (1) a $25 per plane tax, plus (2) a weight tax of 3½ cents/pound for turbine-powered (jet) aircraft and 2 cents/pound for nonturbine-powered aircraft for each pound in excess of 2,500 pounds of maximum certificated takeoff weight.

[5] Taxed at the general rates for nonhighway tires (5 cents/pound before Jan. 1, 1981, and 4.875 cents/pound thereafter) and inner tubes (10 cents/pound).

Pros and Cons

Arguments for the proposals

1. The airport and airway system costs should be financed primarily by, and the costs distributed fairly among, users of the system, rather than by the general taxpayer. Thus, the aviation user taxes should be sufficient to finance the necessary airport and airway system costs.

2. The aviation excise taxes should be dedicated to the Airport and Airway Trust Fund in order to make sure the revenues are used for airport and airway system purposes rather than general purposes.

3. General aviation users should pay an appropriate share of the system costs. The prior law tax level (7 cents per gallon) is insufficient and should therefore be increased.

Arguments against the proposals

1. An air passenger ticket tax above 5 percent is too high at the present time because the existing trust fund uncommitted balance would be more than sufficient to finance trust fund expenditures in the near term.

2. An increase in the air passenger ticket tax at this time would harm the airline industry and would be unfair because commercial airlines already pay their share of the system's expense.

3. The air freight tax should be at a lesser tax rate than for passengers, as was the case under prior law.

4. The 12-cent per gallon (or higher) tax rate for noncommercial aviation fuels would be too high and would unduly burden general aviation operations.

Revenue Effect

[Fiscal years, billions of dollars [1]]

Item	1983	1984	1985	1986	1987
Administration proposal	1.2	1.4	1.5	1.7	1.9
Ways and Means Committee bill (H.R. 4800)[2]	.4	.1			

[1] Net increase in revenues over present law taxes.

[2] The additional aviation taxes over present law would be effective for July 1, 1982, through Dec. 31, 1983.

L. Withholding on Interest and Dividends

Present Law

Present law requires information reporting for payments of most types of interest and dividends but does not require withholding on such payments, except in the case of payments to certain foreign persons. Among the types of payments for which there are no information reporting requirements are payments of interest on bearer obligations, unless received and paid over by nominees.

Administration Proposal [1]

Overview

The Administration proposes withholding on dividend and interest payments at a flat 5-percent rate, beginning on January 1, 1983. Generally, the proposal would require withholding on payments by commercial and financial institutions and similar organizations to individuals, partnerships, and certain trusts, in generally the same manner that tax is withheld on wages, except that such withholding would be at a flat rate. Payments to corporations, including regulated investment companies (e.g., mutual funds), would not be subject to withholding; thus, intercorporate dividends and most commercial or financial transactions would be unaffected. Interest payments made by individuals, generally, would not be subject to withholding.

In addition, the proposal would extend the information reporting requirements to any payments to noncorporate recipients of taxable interest or accruals of original issue discount on all debt obligations of the sort generally offered to the public.

Recipients of taxable interest, original issue discount, or dividends would be required to attach to their income tax returns statements received from payors, showing the amount of the taxable item and the amount of tax withheld, just as is currently required for wage statements (W–2's) received by employees. Individuals making estimated tax payments could reduce their estimated tax payments by an amount equal to the withholding credit to which they would be entitled as of the payment date. Because of liberalizations on the wage withholding rules enacted in ERTA, individual wage earners would be able to adjust their withholding allowances to reflect some or all of the amount of taxes which would be withheld from their dividend and interest income.

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[1] At a Ways and Means Committee hearing on May 5, 1982, Treasury Secretary Donald Regan stated that the Administration was no longer including withholding on interest and dividends as part of its package of revenue-increase proposals.

Time of withholding

In general, withholding would occur when the taxable interest or dividend would be includible in the gross income of the taxpayer. In the case of cash payments, withholding would occur when the payment is made. In the case of constructive payments, withholding would occur at the time of constructive receipt.

Special rules would be provided for payments of interest on accounts with depository institutions. Ordinarily, withholding would occur when an amount is posted to the account; however, an option would be provided for depository institutions to withhold from passbook accounts, interest bearing checking accounts and similar accounts on an annual basis. The withholding would be accelerated if an account were to be closed, and the account could not be reduced beyond the accrued withholding obligation with respect to the account.

Exemptions from withholding

Under the proposal, payments made to two classes of recipients would be exempt from withholding. First, taxable dividend and interest payments made to corporate recipients would not be subject to withholding. These corporate recipients would, however, withhold from any further distributions of dividends or interest to non-exempt persons.

Secondly, the proposal would exempt from withholding payments made to certain persons who file exemption certificates with the payor. Persons eligible to file exemption certificates would include (1) individuals who had no income tax liability in the preceding taxable year and who reasonably expect to have no income tax liability for the current taxable year; (2) individuals 65 years of age or older who had tax liabilities of not more than $500 ($1,000 for married couples filing jointly) for both their prior and current taxable years (the Administration estimates that over 70 percent of all elderly persons would be exempt from withholding); (3) organizations, including State and local governments, exempt from income taxation (such as those described in sec. 501(a)); (4) noncorporate dealers in securities required to register as broker-dealers; and (5) noncorporate nominees. Individuals would not be allowed partial exemptions from withholding to reflect the $100 or $200 dividend exclusion or 15 percent net interest exclusion (effective after 1984) provisions. No withholding would be required on interest paid on All-Savers certificates or tax-exempt bonds.

Pros and Cons

Arguments for the proposal

1. Individuals who fail to report income from interest and dividends pay less than their fair share of tax; a significantly smaller proportion of interest and dividend income is reported on tax returns than of wage and salary income. Recovering such lost tax revenues through withholding on interest and dividends would be both an efficient and equitable step to take.

2. Recipients of interest and dividends should pay their taxes with no less certainty than persons who receive wages that are subject to withholding, and those taxes should be paid just as promptly.

3. The failure of some taxpayers to report interest and dividend income diminishes public respect for the tax system and reduces the extent of voluntary compliance. Experience has shown that withholding is the most effective method to improve compliance in the reporting of income.

Arguments against the proposal

1. Withholding a portion of dividend and interest income could drive funds away from corporate equities, bonds, and other savings mechanisms.

2. Withholding would lower the real rate of return on some investments by denying investors the use of withheld funds. This could make investments less attractive.

3. Withholding would impose extensive operating cost burdens on savings institutions and increase paperwork burdens.

4. A better approach for improving compliance on interest and dividends would be to improve the information reporting system.

Revenue Effect

[Fiscal years, billions of dollars]

1983	1984	1985	1986	1987
2.3	2.0	2.4	2.8	3.3

II. OTHER PROPOSALS

A. Compliance

Present Law and Background

The internal revenue laws impose income taxes on individuals, estates, trusts, corporations, and other organizations. These taxes are levied and collected under a system of self-assessment which requires taxpayers to file returns reporting income, losses, deductions, credits, and other information necessary to compute their tax liability. This system covers foreign as well as domestic transactions.

To assure compliance with the self-assessment system, the tax law imposes a variety of requirements both on taxpayers and on other persons. These include minimum filing requirements, recordkeeping requirements, withholding tax requirements, estimated tax payment requirements, and information reporting requirements. Taxpayers who fail to pay or who underpay their tax are subject to interest charges and may incur penalties. Similarly, failure to file required information returns and statements may result in imposition of penalties. The tax law also provides administrative and judicial rules relating to the examination, assessment, and collection of taxes.

Currently, the Internal Revenue Service estimates that, under present law, the revenue loss resulting from noncompliance may be approximately $95 billion in 1981. The Internal Revenue Service projects a compliance gap of approximately $133 billion in 1985 absent any change in the tax laws or the current level of enforcement funding. The preliminary data shows underpayments of $91 billion by individuals (including $8 billion attributable to criminal activities) and $4 billion by corporations.

Of the $83 billion estimated underpayment by individuals engaged in legal activities, $66 billion results from underreporting of income, $12 billion from overstatement of deductions, credits, and exemptions, and $5 billion from failures to file tax returns. At the present time, the Internal Revenue Service has no estimate of the extent of the tax gap attributable to taxpayers owning overseas businesses or investments. One of the principal reasons for this has been its inability to examine adequately the books and records of many offshore enterprises. This is particularly true for businesses operating in tax haven countries.

Compliance rates by selected income source according to Internal Revenue Service preliminary estimates are shown in table 3 below.

TABLE 3.—IRS ESTIMATES OF TAX COMPLIANCE RATES, SELECTED INCOME SOURCES, 1981 (PRELIMINARY)

[In percent]

Source		Source	
Wages	99	Pensions	80
Farm business	92	Nonfarm business	80
Interest	89	Capital gains	56
Dividends	85	Tip income	16
State tax refunds	81	Illegal income	5

Possible Proposals

Compliance with the income tax laws could be improved by adopting a number of new provisions to address specific tax compliance challenges.

a. Amendments to the Internal Revenue Code

(1) Information reporting

The current information reporting system could be improved by providing the Internal Revenue Service with additional and more accurate information. Reporting with respect to interest could be improved by requiring registration of most long-term debt obligations and by requiring reporting of payments of interest (including original issue discount) on bearer bonds, Federal debt obligations and certain other obligations. Information reporting could also be required on securities and commodities transactions effected through brokers (including barter exchanges), tip income, transactions involving independent contractors and direct sellers, and State and local tax refunds. The quality of information received could be improved by increasing the penalties upon persons who fail to comply with information reporting requirements and by imposing withholding on persons who fail to supply their taxayer identification numbers or who supply incorrect numbers. To insure the continued information gathering capability of the Internal Revenue Service, an exemption could be provided from the Paperwork Reduction Act and its targeted 25-percent reduction in information collection.

(2) Withholding on pension and annuity payments

Compliance with respect to pension and annuity payments could be strengthened through improved recordkeeping and reporting. The voluntary withholding system on annuities could be modified to require withholding on annuities, under the wage withholding rules, unless the taxpayer elected out on an annual or other basis. In addition, mandatory withholding on lump sum distributions could be instituted.

(3) Penalties

A minimum penalty for the failure to file a tax return could be imposed, together with penalties for filing frivolous tax returns. Persons who aid or abet others in the violation of tax laws or who cause others to file false returns could be subject to a new penalty. Finally, certain taxpayers who have substantially underreported their tax liability could be penalized.

(4) Interest

The rules relating to computation of interest under the tax laws could be amended to require compound (rather than simple) interest, to limit interest on certain loss and credit carrybacks and on delinquent returns, and to adjust the rate of interest semi-annually based upon an average prime interest rate.

(5) Foreign transactions and taxpayers

Compliance with respect to tax liability arising from foreign activities could be improved through provisions designed to permit simplification of returns and information statements on such activities, and to strengthen the penalties for failure to supply information and to file required returns and statements. Withholding could be imposed under the Foreign Investment in Real Property Tax Act.

(6) Partnership audits

The resolution of income tax issues arising with respect to partnerships and subchapter S corporations could be simplified by providing for a single administrative and a single judicial proceeding.

(7) Administrative summonses

Taxpayers seeking to challenge an Internal Revenue Service summons to a third-party recordkeeper could be required to petition a court to quash the summons. Enforcement of the summons could be delayed pending appeal in limited circumstances. A brightline rule could be provided with respect to the use of administrative summonses in civil tax cases with criminal aspects.

(8) Independent contractors

Compliance by independent contractors and other self-employed persons could be improved by providing a safe harbor test clarifying the definition of independent contractors under current law. The safe harbor would be available only for payors who complied with the information reporting rules and provided workers with a written reminder of their tax responsibilities. Audit procedures in employment tax cases involving a worker's status as an employee or an independent contractor could be streamlined by reducing the amounts assessable by the Internal Revenue Service for unpaid employment taxes where the employer acted in good faith, as evidenced by compliance with information reporting rules. In addition, judicial review of Internal Revenue Service employment tax adjustments could be permitted prior to assessment, or prior to collection action.

(9) Other options

(a) *Mandatory pension withholding.*—Mandatory withholding could be imposed on all pension and other annuity distributions, under a system similar to withholding on wages. Thus, as in the case of withholding, no tax would be withheld on payments of $7,400 a year or less made to a couple 65 years of age or older. Similarly, pensioners who owed no tax in the prior year and who expect to owe no tax for the current year could claim exemption from withholding. If a person failed to file an exemption certificate, he could be presumed to have claimed one withholding exemption.

(b) *Fraud and negligence penalties.*—The percentage amount of the fraud and negligence penalties could be increased and the base for the penalty could be limited to that portion of the underpayment due to fraud or negligence.

(c) *Investment advisers and promoters.*—A penalty could be imposed and injunctive relief allowed against advisers and promoters who commit fraud or provide a substantial overvaluation with respect to a deduction or credit.

(d) *Allocation of tips.*—A safe harbor could be provided with respect to the amount of tip income that must be reported by employers and included in the income of employees. Specifically, employers could be required to allocate an amount equal to a fixed percentage of their gross receipts (e.g., 12 percent) among their employees. Employees could be permitted to report lower amounts on the basis of adequate records. In certain cases, such as fraud, the Internal Revenue Service would be allowed to prove that an employee had received higher amounts of tip income.

(e) *Jeopardy assessments.*—Collection of taxes could be explicitly presumed to be in jeopardy when the taxpayer is engaged in an illegal activity or when large amounts of cash or its equivalent have no readily ascertainable owner.

(f) *Estimated tax penalties.*—A reasonable cause defense to the penalty for underpayment of the estimated tax could be allowed.

(g) *Casualty insurance reimbursements.*—Information reporting could be imposed upon certain casualty insurance reimbursements.

(h) *Tax havens.*—Other limitations on the use of tax havens could be imposed.

b. Internal Revenue Service funding

Additional funds could be appropriated to the Internal Revenue Service. Such funds could be used to expand the number of collection personnel of the Internal Revenue Service by 3,000, as requested by the Administration. In addition, such funds could be used to expand the examination staff of the Internal Revenue Service by 2,000, as requested by the Administration, or by the substantially higher numbers necessary to restore audit coverage to historical levels. Finally, funds could be provided to expand the data processing operations of the Internal Revenue Service to increase the amount of data entered into its taxpayer master files, to increase the number of tax returns matched, to reduce the thresholds for investigating discrepancies between amounts shown on information returns and amounts reported by taxpayers and for other tax return processing purposes.

Pros and Cons

Arguments for the proposals

1. The taxes of complying taxpayers should not be raised to make up for the revenue shortfall which would result in the absence of every reasonable effort to assure collection of the taxes already imposed and owing under the law.

2. The rate of voluntary compliance with the income tax laws has declined steadily in recent years. Failure to adopt limited solutions currently may require adoption of other measures such as mandatory withholding on dividends, interest, and other non-wage payments in the future.

3. Wage earners have a high rate of compliance because they are subject to withholding. Compliance by other taxpayers must be improved to assure that the tax burden is equitably shared by all.

4. The information reporting system has not been significantly revised since 1962. The advances in information processing technology since that time justify strengthening the information reporting system.

5. The voluntary self-assessment system depends on taxpayer perceptions that the system is fair and effective. Widespread noncompliance undermines this perception. However, an increase in Internal Revenue Service funds for enforcement will help assure taxpayers that the system is being fairly and effectively administered.

6. The penalties on tax shelters and the improvement in compliance generally resulting from the proposals would encourage taxpayers to invest in more productive activities rather than in activities that primarily provide an opportunity for tax evasion.

7. The information reporting provisions will assure that taxpayers are informed of items includible in income, thereby increasing compliance.

Arguments against the proposals

1. The compliance proposals, taken as a whole, could create an atmosphere of suspicion and distrust between the Internal Revenue Service and taxpayers.

2. A more effective approach to improving voluntary compliance would be to simplify the tax laws and to make them more equitable.

3. Several of the proposed provisions (such as the penalty for frivolous returns, the presumptions of jeopardy, the use of administrative summonses in cases with criminal aspects, and the restrictions on the right to challenge third-party summonses) may raise questions of fairness and due process which deserve careful scrutiny.

4. The increased paperwork and compliance costs associated with information reporting would adversely affect third parties not responsible for noncompliance by shifting to them the costs of compliance.

5. A comprehensive taxpayer education program would be a fairer and less burdensome solution to any compliance problems that may exist.

Revenue Effect

The revenue effect would depend on the details of the proposal. For example, enactment of S. 2198, which essentially embodies possible proposals to amend the Internal Revenue Code numbered (1) through (4) above, is estimated to increase fiscal year budget receipts by $2.2 billion in 1983, $3.4 billion in 1984, $4.7 billion in 1985, $5.7 billion in 1986, and $6.4 billion in 1987.

B. Income Tax Proposals Primarily Affecting Individuals

1. Tax-Qualified Pension Plans and Railroad Retirement Benefits

a. Limits on contributions and benefits under qualified plans

Present Law

Overall limits

Present law provides special tax treatment for employers who maintain tax-qualified pension, profit-sharing, and stock bonus plans, and for employees who are covered by these plans. Generally, (1) employer contributions are deductible (within limits) when made; (2) employees are not taxed on plan benefits until those benefits are distributed; (3) a trust which meets the qualification rules is tax-exempt; (4) 10-year forward income averaging and capital gains treatment generally are provided for lump sum distributions of benefits; and (5) estate and gift tax exclusions are provided.

Under the qualification rules for defined contribution plans (e.g., profit-sharing plans), the annual addition with respect to each plan participant (consisting of employer contributions, certain employee contributions, and forfeitures allocated from the accounts of other participants) is limited to the lesser of 25 percent of compensation for the year, or $25,000 adjusted for inflation according to increases in the consumer price index (CPI) since 1974 ($45,475 for 1982).

Under a defined benefit pension plan, the annual benefit derived from employer contributions is generally subject to an overall limit of the lesser of (1) 100 percent of average compensation for the highest-paid three consecutive years or (2) $75,000, adjusted for inflation (CPI) since 1974 ($136,425 for 1982). The annual benefit is the equivalent of a retirement benefit for the life of the employee, without regard to certain survivor benefits. If the retirement benefit begins before age 55, the annual limit of $136,425 (for 1982) is reduced to the actuarial equivalent of an annual benefit of $136,425 (for 1982) beginning at age 55.

If an employee participates in a defined contribution plan and a defined benefit plan maintained by the same employer, the fraction of the separate limit used by each plan is computed and the sum of the fractions is subject to an overall limit of 1.4 under the qualification rules (giving credit for prior years in which the limit was not reached). For example, if the annual additions under a defined contribution plan are 5/10ths of the defined contribution limit, then the annual benefit earned under the defined benefit plan could not exceed 9/10ths of the defined benefit limit for the year.

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Special limits for plans of self-employed individuals

Annual deductible contributions to a profit-sharing or other defined contribution plan which benefits a self-employed individual (an H.R. 10 plan) are limited to the lesser of $15,000 or 15 percent of net self-employment earnings. The 15-percent rate corresponds to 17.6 percent of net earnings after the contribution is taken into account. For a defined benefit H.R. 10 pension plan, a special schedule limits benefit accruals to correspond to the defined contribution limit. The same or equivalent contribution and benefit limits apply to plans of subchapter S corporations and to simplified employee pensions (SEPs).

Retirement plans of "incorporated professionals" are subject to the same limits that apply to other corporate plans (e.g., for a profit-sharing plan, 1982 contributions are limited to the lesser of 25 percent of compensation or $45,425).

Possible Proposals

1. The limits could be reduced to $30,000 (defined contribution plans) and $90,000 (defined benefit plans).
2. Future cost-of-living adjustments to the limits could be reduced or eliminated.
3. The aggregate 1.4 limit for an employee who participates in both a defined benefit plan and a defined contribution plan of the same employer could be reduced so that the sum of the fractions of the separate limit used by each plan would be subject to a lower limit, for example, 1.25 or 1.0. Also, the 1.4 fraction might be reduced only with respect to the dollar limits, and not with respect to the percentage of compensation limits, or a *de minimis* amount of pension benefits could be disregarded in computing the combined limit.
4. The $90,000 annual benefit limit could be required to be actuarially reduced if benefit payments begin before age 62 and actuarially increased if benefit payments begin after age 65.
5. Post-retirement medical benefits provided to the retiree (or the retiree's spouse or dependent) under the plan could be taken into account under the annual benefit limit.
6. The limits for H.R. 10 plans, plans of subchapter S corporations, and SEPs could be increased by indexing until they are equal to the overall limits for plans of corporate employers.

Pros and Cons

Arguments for the proposals

1. The present-law limits on tax-favored retirement savings are too generous. High income individuals affected by the proposed reductions in the limits can afford to provide for a portion of their retirement needs without a tax benefit (e.g., additional benefits can be provided under unfunded plans which receive no subsidy). A tax incentive of the magnitude of the present-law [illegible] is unnecessary.
2. Though it may be desirable to encourage cost-of-living increases for plan participants, it is not necessary to provide similar adjustments to the overall limits on contributions and benefits qualifying for tax subsidy. If required, adjustments should be accomplished by periodic Congressional action.

3. The proposal would raise significant revenues without decreasing the tax incentive of most employers to provide pension benefits. Reductions would be required for only a small percentage of plan participants.

4. The proposal would reduce the difference between the limits for plans of corporate employers and those for self-employed individuals. This would reduce the incentive for partnerships and sole proprietors to incorporate their practices solely to take advantage of the higher limits.

5. Requiring that the $90,000 benefit limit be reduced if benefits commence before age 62 and increasing the limit if benefits commence after age 65 would be consistent with current retirement policy to encourage later retirement and with public retirement systems that require actuarial reduction upon early retirement.

6. Reqiuring actuarial reductions in the $90,000 benefit limit would preclude establishment of an artificially early retirement age merely to accelerate deductions for pension plan contributions.

Arguments against the proposals

1. Any reduction in the present-law limits is not justified because these limits represent no more than inflation-adjusted limits which were acceptable in 1974 when ERISA was enacted.

2. The reduction of the present-law limits would reduce the incentive for employers to maintain a pension plan and thus could lead to plan terminations and benefit cuts for rank-and-file employees.

3. The proposals would require employers to undertake the expense of amending their plans.

4. If overall limits on contributions and benefits are reduced, it is inappropriate to repeal cost-of-living adjustments designed to prevent further reductions caused by inflation. Periodic Congressional action designed to permit increases would be inconsistent with adequate advance funding because some plans would require time to fund for the higher benefit levels.

5. Reduction of the present-law limits would encourage more employers to provide benefits through nonqualified, unfunded excess benefit plans which are not subject to ERISA provisions requiring vesting and nondiscriminatory coverage and benefits.

6. If the proposal for increasing the limits for H.R. 10 plans is adopted, wealthy individuals who participate in such plans would be given a tax cut.

Revenue Effect

[Fiscal years, billions of dollars]

Item	1983	1984	1985	1986	1987
$30,000/$90,000 limits; no COLA adjustment; 1.0 overall limit; revise actuarial adjustment for retirement age; include post-retirement medical benefit in limit; index H.R. 10 limit	.3	.8	.9	1.1	1.3

b. Loans to plan participants

Present Law

A qualified plan generally is permitted to lend to a participant if certain requirements are met. Generally, the loan must bear a reasonable rate of interest, be adequately secured, provide a reasonable repayment schedule, and be made available on a basis which does not discriminate in favor of employees who are officers, shareholders, or highly compensated. However, an H.R. 10 plan is not permitted to lend to a self-employed individual whose ownership interest exceeds 10 percent, and a subchapter S corporation's plan is not permitted to lend to a shareholder-employee owning more than 5 percent of the corporation's stock. Also, if a self-employed individual participating in an H.R. 10 plan borrows from the plan or pledges an interest in the plan as security for a loan, the transaction is treated as a plan distribution, and the usual tax rules for distributions apply.

Under a cash or deferred profit-sharing or stock bonus plan, the employee is given the choice of being paid a specified amount in cash as current compensation or having that amount contributed to the plan, in which case the amount is excluded from income. Loans are permitted under these plans. Loans are also permitted under tax-sheltered annuity programs.

Possible Proposals

1. Plan loans or pledges by a participant in excess of a specified amount could be treated as a distribution, and thus included in the participant's income.
2. A loan or pledge other than upon a showing of disability or emergency, could be treated as a distribution.
3. Loans and pledges made under cash or deferred arrangements or tax-sheltered annuity contracts could be treated as distributions.

Pros and Cons

Arguments for the proposals

1. Under present law, many individuals make deductible contributions of their income to a plan and then borrow back the contribution, thus receiving their income tax-free and further benefiting from interest deductions associated with the repayment of the loan and from possible estate tax deductions and exclusions. In this situation, pension plans are simply a device for inappropriately reducing tax liability.
2. Restricting loans and pledges under qualified plans would improve the likelihood that the plans would function to increase retirement savings.
3. It is appropriate to preclude an individual from electing to defer income on a tax-free basis under a cash or deferred plan and then borrowing it back.

4. The proposed rules for plans and tax-sheltered annuity programs would be similar in effect to the anti-borrowing restrictions currently imposed on IRA owners, self-employed individuals under H.R. 10 plans, and shareholder-employees under plans maintained by subchapter S corporations.

Arguments against the proposals

1. The proposals could disrupt financial plans of people who made plan contributions and expected to borrow back the funds.

2. Any proposal which limits individuals' access to plan assets will make them more reluctant to make plan contributions, and thus could decrease retirement security and aggregate savings.

Revenue Effect

[Fiscal years, billions of dollars]

1983	1984	1985	1986	1987
([1])	([1])	([1])	([1])	([1])

[1] Increase of less than $50 million.

c. Integration with social security

Present Law

A retirement plan does not qualify for special tax treatment unless it satisfies rules designed to assure coverage of either a significant part of the employer's work force or a classification of employees that does not discriminate in favor of employees who are officers, shareholders, or highly compensated. In addition, with respect to the group of employees actually covered by a plan, the plan must not discriminate in favor of employees who are officers, shareholders, or highly compensated by providing them with contributions or benefits which are a higher percentage of their pay than the contributions or benefits provided for other employees.

Integration of defined benefit pension plans

Under present law, in determining whether pension plan benefits, as a percentage of pay, discriminate in favor of employees who are highly compensated, the portion of each employee's social security benefits considered paid for by the employer may be taken into account. If those social security benefits and the employer-provided benefits under the plan, when added together, do not provide an aggregate pension which is a higher percentage of pay for highly compensated employees than for other employees, the benefits under the plan are considered not to discriminate in favor of highly compensated employees.

Under present law, the IRS has determined that the employer-provided social security benefits are equal to (1) 83⅓ percent of the basic social security benefit (the annual primary insurance amount, or PIA) to which an employee is entitled under social security, or (2) 37½ percent of the employee's covered compensation (the maximum pay on which the employee's social security benefits are based).

Thus, a defined benefit plan can integrate with social security either by (1) reducing the employee's plan benefits by up to 83⅓ percent of the employee's PIA (an offset plan), or (2) providing benefits at a rate of up to 37½ percent on pay in excess of the highest annual wage used to compute the employee's social security benefit ($11,004 for an individual attaining age 65 in 1982), and providing no benefits on pay below that annual wage (an excess plan).

The integration formulas allow an employer's plan to reduce the employee's plan benefits on account of social security benefits provided by the present employer and by all prior employers. Thus, the formulas allow multiple and cumulative reductions of plan benefits. That is, when an employee works for a series of employers during a career, the total benefit reductions under all plans of the employers will often exceed the reduction which would be allowed if the employee had worked for only one employer.

Integration of defined contribution plans

A defined contribution plan is also integrated by taking into account the employer-provided benefits under the social security system. Specifically, social security benefits are taken into account by reducing contributions to the plan by the assumed cost of providing social security benefits with respect to the portion of an employee's pay subject to the social security tax. The Internal Revenue Service has determined that the employer's cost of providing social security benefits is 7 percent of pay subject to the tax ($32,400 for 1982). The actual tax rate with respect to Old Age, Survivors, and Disability Insurance (OASDI) benefits is 5.4 percent of the taxable wage base for 1982 through 1984.

Possible Proposals

Defined benefit plans

The integration rules could be revised to prevent an employer from reducing an employee's pension benefit on account of social security benefits earned with another employer.

Defined contribution plans

The credit for integration could be limited to the OASDI tax rate actually in effect at the end of the plan year.

Pros and Cons

Arguments for the proposals

1. These changes relating to multiple employers would protect employee pension benefits against inappropriate reductions under the integration rules because of job changes.
2. The change relating to defined contribution plans would assure that an employer does not reduce the plan contribution for an employee under the integration rules by more than the OASDI tax actually paid for the employee.
3. By reducing social security integration, these changes could increase plan benefits for lower-paid workers.

Arguments against the proposals

1. Because these changes would limit social security integration, they would increase plan costs. Employers could be forced to reduce wages or benefits for lower-paid workers in order to compete with other employers with no plans.
2. The changes could require employers to undertake the expense of amending thousands of plans.
3. The disparity between the present-law 7-percent rate used to integrate defined contribution plans and the actual OASDI rate (5.4 percent for 1982) will decrease in future years due to scheduled increases in the OASDI tax rate. Therefore, it is inappropriate to suddenly eliminate this disparity by requiring expensive plan amendments which would increase plan costs.
4. Because the National Commission on Social Security Reform is currently studying social security and is not scheduled to issue its report until December, 1982, it is inappropriate to amend the integration rules at this time.

Revenue Effect

[Fiscal years, billions of dollars]

1983	1984	1985	1986	1987
(Not available at this time.)				

d. Tier II railroad retirement benefits

Present Law

Taxation of retirement benefits

Under present law, benefits paid to retirees under a retirement plan generally are taxable to the extent that they do not constitute a return of nondeductible employee contributions. This rule also applies to benefits paid under Federal Government plans, such as the Civil Service Retirement System and the military retirement system. However, social security benefits are not taxable.

Railroad retirement benefits

Railroad retirement benefits are divided into two tiers. Tier I benefits are based on the social security formula and are roughly equal to what the social security benefit would have been had the worker's railroad employment been covered by the social security program. Tier I benefits are financed by taxes on employers and employees equivalent to the social security tax rate.

Tier II benefits supplement Tier I benefits and are generally based on the number of years of railroad service and average earnings during the highest earning period of the worker's career. These benefits are financed by an 11.75 percent payroll tax on employers and a 2.0 percent tax on employees.

Both Tier I and Tier II benefits are excluded from gross income.

Possible Proposal

Tier II railroad retirement benefits could be included in gross income under the rules generally applicable to retirement benefits.

Pros and Cons

Argument for the proposal

Tier II benefits supplement Tier I benefits which are equivalent to social security. Accordingly, Tier II benefits should be treated for income tax purposes like any other retirement benefits which supplement social security.

Argument against the proposal

Current retirees have established their standard of living on the assumption that Tier II benefits would not be taxed. It would be unfair to these individuals suddenly to subject their benefits to taxation.

Revenue Effect

[Fiscal years, billions of dollars]

1983	1984	1985	1986	1987
.1	.2	.2	.2	.2

2. Public Utility Dividend Reinvestment Plans

Present Law

ERTA added a provision which allows public utility corporations to set up dividend reinvestment plans under which shareholders electing to receive distributions in the form of common stock, rather than money or other property, may exclude up to $750 per year ($1,500 in the case of a joint return) of the stock distribution from income. These amounts are taxed as capital gains when the stock is sold.

The provision applies to distributions made after 1981 and before 1986.

Possible Proposal

The provision could be terminated for distributions made after December 31, 1982.

Pros and Cons

Arguments for the proposal

1. By giving favorable tax treatment to reinvested public utility dividends, the present-law provision diverts capital away from other industries which might make more productive investments if they could obtain the funds.
2. The provision is inequitable because it provides lower tax liability to an individual whose portfolio contains stocks with qualified programs than to another individual with the same income but with different types of stocks.
3. The provision provides a windfall to those who already owned public utility stock before it was enacted.

Arguments against the proposal

1. The proposal would remove an incentive enacted to help the public utility corporations overcome the difficulties which they have in raising needed capital from external sources. In the past decade, public utilities have not been able to earn adequate rates of return on their investments, and the dividend reinvestment provision is necessary for them to make up for lost ground.
2. The proposal was recently enacted and should not be terminated until its effectiveness can be properly evaluated.
3. The proposal would be unfair to investors who have purchased public utility stocks in reliance on the ERTA provision.

Revenue Effect

[Fiscal years, billions of dollars]

1983	1984	1985	1986	1987
.1	.4	.4	.3	----------

3. Exclusion for Employer Health Plan Payments

Present Law

All employer contributions to employee health plans are excluded from an employee's income and wages for purposes of income and payroll taxes. This tax treatment applies regardless of the benefits or coverage of the plan.

Possible Proposal

A limit could be placed on the amount of employer contributions to a health plan which could be excluded from an employee's income and wages for purposes of the income tax, withholding, FICA, and FUTA.

The limit could be a specified dollar amount per month of coverage. The dollar amount could depend on the type of coverage selected by the employee, e.g., $80 per month for individual coverage and $200 per month for family coverage. The limits could be adjusted annually according to increases in the consumer price index.

Special rules could be provided for computing the income and payroll tax liability resulting from contributions to multiemployer plans. These rules could provide that the fraction of these contributions not includible in income would be determined by the ratio of the applicable cap to the plan cost per employee.

For self-insured plans, the amount subject to income and payroll taxes could be based on reasonable estimates of per-employee cost using actuarial factors. A saft harbor rule could provide that an estimate made for any estimation period (e.g., a calendar year) will be deemed reasonable if it (1) is not less than the actual per-employee cost for claims paid during a preceding base period (adjusted for projected increases in plan costs), and (2) turns out to be not less than 80 percent of the actual per-employee cost for the estimation period. Under this rule, the base period could be defined as the 12-month period ending 3 months before the estimation period (e.g., if the estimation period is the calendar year, the base period is the 12-month period ending on the preceding September 30). For projecting increases in plan costs, the projection factor could be the percentage increase in the CPI medical care component for the 15-month period ending with the end of the base period, plus 4 percent.

Pros and Cons

Arguments for the proposal

1. The present law exclusion creates an inequity in the tax system, since an individual all of whose compensation is in cash and who provides for his or her own health care must pay for health care out of after-tax dollars, while the employee covered by an employer paid medical plan pays for health care with before-tax dollars. There-

fore, the noncovered employee pays more tax than the covered employee who has the same amount of compensation, but receives part of it in the form of tax-free health insurance.

2. The exclusion provides a greater benefit to the high bracket taxpayer than to the low bracket taxpayer, even though the latter may need a greater incentive to obtain adequate health insurance.

3. Limiting the exclusion would not prevent either an employer or an employee from providing for the same or a higher level of health care than is provided today. It would merely mean that compensation used to provide health care that costs more than the applicable cap would be taxable just like compensation used to purchase most goods and services.

4. The present-law exclusion provides an incentive for the purchase of an unlimited amount of health insurance. As a result, many individuals have health plans which cover virtually every possible expense. These individuals (and their doctors) treat health services as if they were free, which may cause the use of many services that have marginal value or are unnecessarily expensive. The proposed limit, which affects only the most expensive health plans, would eliminate the tax incentive to participate in plans which include coverage which is of little value in treating disease or maintaining good health.

5. Because the exclusion is unlimited, individuals and employers who choose inefficient health plans receive a greater subsidy than those who choose efficient plans (such as HMOs) providing the same level of benefits. Thus, the exclusion reduces the pressure on, and interferes with the incentives for, health care providers to minimize costs.

6. An exclusion limit which is uniform across the United States is consistent with the overall tax system, which, for reasons of equity and simplicity, does not recognize cost-of-living differences among different regions or individuals of different pre-retirement ages.

7. The proposed limit is so high that it will affect only those who already have very extensive health coverage. The reduction in coverage which the proposal may induce thus would have only a small effect on out-of-pocket medical expenses.

Arguments against the proposal

1. The cost of a given amount of health insurance is greater in some areas than others and for some groups (e.g., employee groups consisting mostly of older workers) than others. A dollar cap which is the same for everyone would discriminate against high cost groups, since employees who are in these groups and whose employer contribution is greater than the cap would pay higher taxes than employees in low cost groups with the same benefit coverage.

2. If the limit on the exclusion leads to a reduction in insurance coverage, then individuals who suffer from illnesses will have higher out-of-pocket medical expenses.

3. Coverage for lower income workers, who can least afford increased medical expenses, could be reduced.

4. Reduced insurance coverage, i.e., higher patient deductibles and copayments, could lead to less use of outpatient services and preventive care, which are cost-beneficial expenditures.

5. There will be administrative difficulties in assessing tax liability on contributions to self-insured and multiemployer plans.

Revenue Effect

[Fiscal years, billions of dollars]

Item	1984[1]	1985	1986	1987
Cap on health plan exclusion:				
1. $200/month for family coverage:				
a. Indexed for CPI	1.9	3.3	4.1	4.9
b. Not indexed	1.9	3.5	4.7	6.0
2. $150/month for family coverage:				
a. Indexed for CPI	4.4	7.6	9.4	11.3
b. Not indexed	4.4	8.1	10.8	13.7

[1] Assumes effective date of Jan. 1, 1984.

Note.—Approximately 25 percent of these amounts are increased social security receipts.

Percentage Change in 1984 Tax Liability

Expanded income (thousands)	Impose a cap of $200/month for family plan; $80/month for single plan
Below $10	.47
$10 to $20	.68
$20 to $30	.93
$30 to $50	1.02
$50 to $100	.75
$100 to $200	.62
Above $200	.42
Total	.87

4. Deduction for Nonbusiness, Nonmortgage Interest

Present Law

Interest paid on debt incurred in connection with a trade or business, or property held for the production of rents and royalties, generally is deductible in computing adjusted gross income. Interest paid on other indebtedness generally is allowed as an itemized deduction.

An individual's deduction for interest paid on amounts borrowed to acquire or carry property held for investment ("investment interest") generally is limited to the individual's net investment income received for the year, plus $10,000 ($5,000 for a married taxpayer filing a separate return). Disallowed investment interest is carried forward to succeeding taxable years subject to the limitation on the deduction in the carryforward year.

Possible Proposal

Limitations could be applied to the deductibility of interest which is not incurred in carrying on a trade or business. The deduction for personal interest, such as finance charges on personal items, could be limited, for example, to $1,000 per year ($2,000 for married taxpayers filing a joint return). The deduction for investment interest, i.e., interest on amounts borrowed to acquire or carry property held for investment, could be limited to the sum of net investment income for the year plus the portion of the $1,000 limitation not used for the deduction of personal interest. Disallowed investment interest could be carried forward to succeeding taxable years.

Alternatively, the deduction for all nonbusinesses interest, whether paid on personal or investment indebtedness, could be limited to the sum of net investment income plus $1,000 ($2,000 for married couples filing a joint return).

An exception from these limitations could be provided for interest on housing debt. This would be debt incurred in acquiring, constructing, reconstructing, or rehabilitating an apartment, house, condominium, cooperative, or principal residence.

A *de minimis* rule could exclude interest on debts incurred for ordinary repairs and maintenance or for minor rehabilitation (e.g., expenditures that do not exceed the greater of $5,000 or 25 percent of the adjusted basis of the dwelling unit). For debt incurred before the effective date of the proposal, for which it could be very difficult to trace the use of loan proceeds, the presumption of use for housing could be created wherever the loan was secured, when incurred, by a lien against the residence.

With respect to the purchase of a replacement residence which qualifies the taxpayer for nonrecognition of capital gain on the sale of the old residence, the interest deduction would not apply to that portion of the mortgage on the replacement residence equal to any gain on the sale which is not invested in the replacement residence.

The limitation could be phased in over several years to allow taxpayers sufficient time to reduce interest expense which would not qualify for the deduction.

The dollar limitation could be replaced by specific exceptions for interest paid on debt incurred for specific purposes, such as the purchase of a passenger automobile or for higher education.

Pros and Cons

Arguments for the proposal

1. The present-law unlimited deduction encourages consumer borrowing, that is, negative savings.

2. Since the deduction presently is available even for borrowing to purchase assets which do not produce income, such as consumer durables, present law encourages the purchase of these assets relative to the purchase of income-producing assets, such as stocks and bonds, which would provide funds for business investment. Thus, limiting the deduction for personal interest would increase the productivity of the economy.

3. The exception for housing interest would preserve the present homeownership incentives in the tax law.

Arguments against the proposal

1. Because money is fungible, it would be very difficult to trace whether the proceeds of specific loans were used for investment, rather than personal, purposes and for housing, rather than nonhousing, purposes.

2. Taxpayers who do not exceed the investment interest limit and who also incur some personal interest would be able to rearrange their portfolios so that interest is characterized as investment, rather than personal, interest. Since investment interest would be deductible up to the amount of investment income, while personal interest would be deductible only up to a fixed dollar amount, this proposal could allow interest deductions to wealthy individuals who do not need to borrow in order to buy a car or appliances.

3. The proposal would draw arbitrary lines, such as between interest on debt used to buy built-in furniture and appliances that are fixtures (interest would be deductible) and interest on debt used to buy freestanding furniture or appliances (interest would not be deductible).

4. Individuals who have large outstanding debts, undertaken in reliance on existing tax law, would be unfairly treated by the proposal.

Revenue Effect

[Fiscal years, billions of dollars]

Item	1983 [1]	1984	1985	1986	1987
Interest limitation (single/married):					
$1,000/$2,000	.4	3.0	3.2	3.4	3.7
$1,500/$3,000	.3	2.1	2.2	2.4	2.5
$2,000/$4,000	.2	1.5	1.6	1.7	1.9

[1] Assumes effective date of Jan. 1, 1983.

Percentage Increase in Tax Liability by Income Class

[In percent]

Expand income (thousands)	Deduction for non-mortgage, non-business interest expense in excess investment income limited to $1,000 ($2,000 for married taxpayer filing a joint return)
Below $10	0.04
$10 to $20	.31
$20 to $30	.69
$30 to $50	1.03
$50 to $100	1.67
$100 to $200	1.86
$200 and over	1.11
Total	1.02

5. Deductions for Sales and Personal Property Taxes

Present Law

An individual who itemizes deductions can deduct State and local general sales taxes (for example, on items of personal clothing) and personal property taxes (for example, annual ad valorem taxes on automobiles and boats used for personal purposes) even though the taxes are not related to business or investment activities. The deductible amount of sales taxes may be computed from tables furnished by the Internal Revenue Service or may be the exact amount of taxes paid. State, local, and foreign taxes incurred in a business or investment activity generally may be deducted in the year paid or incurred, even if the liability arises from the acquisition or disposition of a capital asset. One exception is that individuals and certain corporations are required to capitalize real property taxes incurred during the construction period of real property.

Possible Proposals

1. The deduction for State and local sales taxes paid on items not used in business or investment activities could be repealed. Also, the special rule for taxes incurred in a business or investment activity could be repealed so that taxes other than income and real property taxes, such as sales or other taxes properly chargeable to capital account, could be added to the basis of the asset and recoverable in the same manner as other capital expenditures.
2. The deduction for State and local personal property taxes on property which is not used in a business or investment activity could be repealed. Taxes on real property would continue to be deductible.

Pros and Cons

Arguments for the proposals

1. Repealing nonbusiness sales and personal property tax deductions would discourage consumption and promote saving, and thus would improve the productivity of the economy.
2. Most taxpayers use tables based on average consumption patterns to compute their sales tax deduction in order to avoid the complicated burden of keeping records of hundreds of retail transactions. Thus, the sales tax deduction does not improve the equity of the income tax system because it does not reflect each individual's actual burden of sales taxes.
3. The sales and personal property tax deductions decrease equity since individuals with equal income should pay the same income tax regardless of how they spend their income for personal purposes (e.g., whether for taxable or nontaxable items).

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4. The deduction for personal property taxes discriminates against States which impose nondeductible, flat annual automobile registration fees (which may vary by weights), rather than personal property taxes which vary according to the value of the vehicle.

5. Repealing these deductions would simplify the income tax computation.

6. Taxes that are part of the cost of acquiring or disposing of a capital asset should be treated like other capital expenditures. Capital expenditures are not generally currently deductible, but rather are recoverable after a period of years, e.g., through depreciation or on disposition of the asset.

Arguments against the proposals

1. States which rely disproportionately on sales and personal property taxes would be discriminated against by the proposals. All but five States have general sales taxes. Approximately 30 States have nonbusiness personal property taxes.

2. States would be discouraged from raising revenue by means of sales and personal property taxes. This would be undesirable because the sales tax, especially, is considered by some to be a fair tax.

3. The indirect revenue sharing provided by the Federal tax deductions for these State and local taxes is necessary at a time when other forms of Federal assistance are being reduced.

4. The deductibility of sales and personal property taxes improves the equity of the tax system by allowing taxable income to be adjusted for these mandatory payments.

5. In many areas, personal property taxes on household goods supplement a jurisdiction's real property tax on homes. Thus, personal property taxes should be deductible as long as real property taxes remain deductible.

Revenue Effect

[Fiscal years, billions of dollars]

Item	1983[1]	1984	1985	1986	1987
1. Repeal sales tax deduction	.8	5.2	5.8	6.6	7.5
2. Repeal personal property tax deduction	.1	.6	.6	.7	.7

[1] Assumes effective date of Jan. 1, 1983.

Percentage Increase in Tax Liability by Income Class

[In percent]

Expanded income (thousands, 1981 income levels)	Repeal sales tax deduction	Repeal personal property tax deduction
Below $10	.75	.07
$10 to $20	.76	.07
$20 to $30	1.35	.17
$30 to $50	2.16	.27
$50 to $100	2.14	.27
$100 to $200	1.34	.18
Above $200	.59	.20
Total	1.59	.21

6. Medical Expense and Casualty Loss Deductions

Present Law

Medical expense deduction

Individuals who itemize deductions may deduct two categories of medical expenses. First, a deduction of up to $150 is allowed for one-half of health insurance premiums. Second, a deduction is allowed for all other unreimbursed medical expenditures, including health insurance premiums not allowed in the first category, to the extent that these expenses exceed 3 percent of adjusted gross income. Drug expenditures may be included in the second category only to the extent the total of drug expenditures exceeds 1 percent of adjusted gross income.

Casualty loss deduction

Individuals who itemize deductions may deduct unreimbursed losses of nonbusiness property resulting from fire, storm, shipwreck, theft, or other casualty. The amount of the loss is the lower of (1) the fair market value of the property immediately before the casualty, reduced by the fair market value of the property immediately after the casualty (zero in the case of a theft), or (2) the property's adjusted basis. For any one casualty, the deduction is allowed only to the extent that the amount of the loss exceeds $100.

Possible Proposals

1. The 3-percent floor on the medical expense deduction could be increased, for example, to 5 percent or 10 percent. The separate deduction for a portion of health insurance premiums could be repealed or, alternatively, could be allowed only for taxpayers who do not receive an employer health plan contribution.

2. The deduction for casualty losses could be allowed only to the extent that they exceed, for example, 5 or 10 percent of the taxpayer's adjusted gross income. As under present law, a casualty loss could be taken into account only to the extent that the loss exceeded $100 for any occurrence.

Pros and Cons

Arguments for the proposals

1. The deductions create significant problems of complexity, record-keeping, and audit for both individuals and the Internal Revenue Service, since arbitrary lines must be drawn between deductible expenditures for medical treatment, or sudden casualty losses, and non-

deductible expenditures for ordinary consumption, or losses from gradual deterioration. Taxpayers must keep detailed records for the medical expense deduction and must be prepared to document and defend estimates of fair market value of loss and damaged property for their casualty loss deduction. These difficulties are justifiable only when the amounts involved are significant in relation to the taxpayer's income.

2. The medical expense deduction, with its very broad coverage of such expenses as certain capital expenditures and transportation expenses, creates a subsidy for unnecessary health care spending.

3. The separate deduction for health insurance premiums is allowed even to individuals who also benefit from high levels of tax-free employer health plan contributions.

4. The casualty loss floor has not been raised from $100 since it was established in 1964. This unrealistic floor should be raised, and changed to a percentage of income, in fairness to lower income taxpayers.

5. The casualty loss deduction offsets a higher percentage of losses for high-bracket than for low-bracket taxpayers, even though the latter are less able to purchase insurance to avoid losses and also are more likely to need assistance in coping with expenses.

6. Because these deductions provide, in effect, partial reimbursement of uninsured expenses, they largely constitute "free" government insurance for expenses some of which could be avoided had proper insurance been purchased. Thus, these deductions should be available only when expenses are very large relative to income.

7. Increasing the floors under these deductions will reduce substantially the number of taxpayers using these complicated deductions. Increasing the floor under the medical expense deduction to 5 percent would reduce the number of users by almost 40 percent; a 10-percent-of-income floor under the casualty loss deduction would reduce the number of users of that deduction by 90 percent. A large part of truly catastrophic losses would continue to be deductible.

Arguments against the proposals

1. Taxpayers who suffer unpredictable and unavoidable medical expenses or casualty losses not covered by insurance have a diminished ability to pay Federal income taxes, and this diminished ability should be reflected in tax liability as fully as possible.

2. Some types of health care expenses, even though burdensome in individual cases, are not covered by health insurance policies, such as nursing home care and various forms of custodial care.

3. Income which is used for medical expenses or to compensate for a taxpayer's casualty losses does not increase an individual's net wealth and thus should not be taxed.

4. If an employer pays for health insurance premiums, the payments are excluded from tax, so that repealing the $150 premium deduction would be unfair to those who pay their premiums themselves. At the same time, if this deduction were retained only for individuals not covered by an employer health plan (rather than for all individuals), there would be administrative complexity. Accordingly, the deduction should be retained for all.

Revenue Effect

[Fiscal years, billions of dollars]

Item	1983 [1]	1984	1985	1986	1987
1. Repeal separate deduction for health insurance and increase floor under medical deduction to:					
(a) 5 percent	.3	1.8	2.0	2.1	2.3
(b) 10 percent	.4	3.0	3.2	3.5	3.8
2. Place percentage-of-income floor under casualty loss deduction:					
(a) 5 percent		.5	.6	.6	.7
(b) 10 percent		.7	.7	.8	.9

[1] Assumes Jan. 1, 1983, effective date.

Percentage Increase in Tax Liability by Income Class

[In percent]

Expand income (thousands)	5% floor under medical deduction and repeal separate health insurance deduction	5% floor under casualty loss deduction
Below $10	.31	.03
$10 to $20	.45	.10
$20 to $30	.65	.14
$30 to $50	.83	.23
$50 to $100	.71	.23
$100 to $200	.31	.17
$200 and over	.13	.13
Total	.62	.18

7. July 1983 Tax Rate Reduction and Indexing

Present Law

ERTA provides across-the-board reductions of income tax withholding of 5 percent on October 1, 1981, 10 percent on July 1, 1982, and 10 percent on July 1, 1983. The corresponding cumulative reductions in calendar year tax rates relative to prior law are 1¼ percent in 1981, 10 percent in 1982, 19 percent in 1983, and 23 percent in 1984 and subsequent years. (The income distributional effect of the 1983 tax rate reduction is shown in table 4 following.) Beginning in 1985, the income tax brackets, zero bracket amount, and personal exemption will be adjusted for increases in the consumer price index.

Possible Proposals

All, or a portion, of the July 1983 withholding reduction could be delayed. In addition, indexing could be repealed or delayed, or, alternatively, could be made effective at an earlier date.

Pros and Cons

Arguments for the proposals

1. It might be very difficult to avoid unacceptably high budget deficits or to maintain essential Federal government functions if individual tax rates are cut in July 1983, as scheduled. The tax cut should be delayed until the economy is sufficiently strong and revenues sufficiently high so that the cut will not result in too large a deficit.
2. The inflation rate is considerably lower than what was expected when ERTA was passed. Thus, the rate cuts necessary to compensate for bracket creep are smaller than expected.
3. Substituting earlier indexing for the July 1983 tax cut would insure that bracket creep is eliminated sooner for all taxpayers, including lower income groups which benefit relatively little from across-the-board rate cuts.
4. Because of economic uncertainties, indexing should not be a permanent part of the law until it is clear that budget deficits have been brought under control.

Arguments against the proposals

1. Repeal or delay of the July 1983 rate reductions would decrease the equity of the ERTA rate reductions as a whole, since the highest income taxpayers have already benefited from the immediate reduction of the top income tax rate from 70 percent to 50 percent (see tables below).

2. The long-run benefits of increased work and savings incentives which result from lower marginal tax rates are too important to be sacrificed for temporary revenue increases.

3. Since last summer, individuals have been making investment decisions in reliance on the full 23-percent rate reduction now in the law. It would be unfair and disruptive to the economy to tamper with such an important provision which has been passed so recently.

4. Tampering with indexing could signal to financial markets that the Congress intends to rely on higher inflation, rather than legislative action, to reduce the deficit or to provide additional revenues for spending programs.

TABLE 4.—DISTRIBUTIONAL EFFECT OF THIRD-YEAR (1983) TAX CUT

[Millions of dollars—1981 income levels]

Expanded Income (thousands)	Tax reduction from first two years of rate reductions		Tax reduction from third-year rate reduction		Tax reduction from total 3-year rate reduction		Third-year reduction as percentage of total 3-year rate reduction
	Amount	Percent	Amount	Percent	Amount	Percent	
Below 10	1,198	(2.8)	634	(2.7)	1,832	(2.8)	34.6
10 to 20	5,859	(13.8)	3,360	(14.2)	9,219	(14.0)	36.4
20 to 30	8,469	(20.0)	5,275	(22.4)	13,744	(20.8)	38.3
30 to 50	12,312	(29.1)	7,383	(31.3)	19,695	(29.9)	37.5
50 to 100	7,475	(17.6)	4,558	(19.3)	12,033	(18.2)	37.9
100 to 200	3,311	(7.8)	1,805	(7.7)	5,116	(7.8)	35.3
200 and above	3,750	(8.8)	578	(2.4)	4,328	(6.6)	13.4
Total	42,374	(100.0)	23,592	(100.0)	65,966	(100.0)	35.8

Revenue Effects [1]

[Fiscal years, billions of dollars]

Item	1983	1984	1985	1986	1987
1. Repeal July 1, 1983, rate reduction	7.2	32.4	34.9	36.9	40.0
2. Delay July 1, 1983, rate reduction to Oct. 1, 1983	6.7	.3	----	----	----
3. Delay July 1, 1983, rate reduction to Jan. 1, 1984	7.2	7.1	----	----	----
4. Repeal July 1, 1983, rate reduction and replace with two 5% rate reductions on July 1, 1983, and July 1, 1984, with indexing delayed to Jan. 1, 1986	3.5	12.1	8.8	14.4	15.5
5. Repeal July 1, 1983, rate reduction and advance indexing to July 1, 1983	4.3	13.5	11.9	12.8	14.1
6. Repeal July 1, 1983, rate reduction and advance indexing to Jan. 1, 1984	7.2	23.7	20.6	21.9	23.9

[1] Revenue effects without regard to implied amended rate schedules. Final revenue effects may differ slightly depending on the specification of these new rate schedules.

Percentage Increase in 1984 Tax Liability by Income Class

Expanded income (thousands, 1981 income levels)	Repeal July 1, 1983 rate reduction (percent)	Repeal July 1, 1983 rate reduction and make indexing effective on that date
Below $10	10.65	−7.78
$10 to $20	11.15	1.28
$20 to $30	11.98	3.18
$30 to $50	11.59	3.15
$50 to $100	11.71	4.12
$100 to $200	9.65	5.26
$200 and above	3.51	2.18
Total	10.83	2.88

C. Income Tax Proposals Primarily Affecting Corporations

1. Capital Cost Recovery

a. Basis adjustment for investment credits

Present Law

In general, a taxpayer is allowed cost recovery deductions for 100 percent of the cost (or basis) of a depreciable asset, including property for which a regular or energy investment tax credit, or the 25-percent investment credit for rehabilitation expenditures for certified historic structures, is allowed.

However, if the 15- or 20-percent investment credit is claimed for qualified rehabilitation expenditures on a nonresidential building, the basis of the property must be reduced by the amount of credit. This lower basis is used to compute cost recovery deductions and capital gain or loss.

Possible Proposal

In addition to the basis reduction currently required for the 15- and 20-percent rehabilitation expenditure credits, taxpayers could be required to reduce the basis of a depreciable asset by the full amount (or, alternatively, one-half of the amount) of regular and energy investment tax credits and of the 25-percent rehabilitation expenditure credit for certified historic structures.

Pros and Cons

Arguments for the proposal

1. A taxpayer should not be allowed cost recovery deductions for that portion of asset cost which has, in effect, been paid for by tax credits.

2. For most personal property, the cost recovery deductions currently allowed under ACRS, in combination with investment credits, generate tax benefits the present value of which is more generous than the tax benefits of expensing—that is, a full deduction of cost in the year of investment. This results in negative effective tax rates and subsidizes uneconomic investment (which is investment that would not be undertaken if there were no income tax). The proposal would mitigate these effects.

3. The rapid cost recovery under the ACRS system will eliminate the tax liability of many corporations, leaving them with excess deductions and credits from which they do not receive full benefit. This creates an incentive, based solely on tax considerations, for these corporations to merge with taxpaying corporations which can benefit from the otherwise unused deductions and credits.

4. A basis adjustment for one-half the amount of credits allowed would make the combination of ACRS cost recovery deductions and the regular investment credit equivalent to expensing at a 10-percent after-tax discount rate. These benefits would provide investment incentives comparable to incentives that would exist in the absence of an income tax, and thus encourage the private sector to undertake the maximum amount of productive investment.

Arguments against the proposal

1. Tax benefits more generous than expensing are necessary to offset disincentives to investment, such as the double taxation of dividends, and to make up for the shortfall in capital formation that has built up over the past decade.

2. Some businesses may have planned or undertaken investment programs for 1983 that would be profitable after taxes only if investment incentives are not reduced.

3. A basis adjustment for the full amount of investment credits would mean that some taxpayers would have higher effective tax rates than they had before the enactment of ACRS.

4. The discount rate under which it is concluded that the present system is more generous than expensing would be inappropriately low if inflation and interest rates increase significantly, in which case a basis adjustment for one-half of the regular credit would make ACRS less generous than expensing.

5. The proposal may involve technical complexities if, for example, the investment credit is recaptured because of a change of use which does not also trigger depreciation recapture or if the credit is not fully used in the year earned.

Revenue Effect [1]

[Fiscal years, billions of dollars]

Item	1983 [2]	1984	1985	1986	1987
Basis adjustment for:					
100% of credits	.8	2.7	5.0	8.1	11.1
50% of credits	.4	1.3	2.5	4.0	5.5

[1] These estimates do not take into account interaction with safe-harbor leasing.
[2] Assumes an effective date of Jan. 1, 1983.

b. Reduction in regular investment tax credit

Present Law

A taxpayer can claim a regular investment tax credit, in addition to depreciation deductions, for tangible personal property and certain other tangible property (generally not including buildings or structural components) used in connection with manufacturing or production. The amount of this credit is 6 percent of the cost of property which is in the 3-year recovery class, and 10 percent of the cost of eligible property which is not in the 3-year class.

In general, the regular investment credit is claimed for the taxable year in which the property is placed in service. This credit may be used to offset the first $25,000 of tax liability plus 90 percent of tax liability in excess of $25,000.

Possible Proposal

The regular investment credit could be reduced to either 4 or 5 percent for property in the 3-year recovery class, and to 7 or 8 percent for eligible property which is not in the 3-year class.

Pros and Cons

Arguments for the proposal

1. For most personal property, the regular investment credit and cost recovery deductions currently allowed under ACRS generate tax benefits that are more generous than the tax benefits of expensing—that is, a full deduction of cost in the year of investment. This results in negative effective tax rates and subsidizes uneconomic investment (which is investment that would not be undertaken even if there were no income tax). The proposal would mitigate these effects by making benefits slightly less generous than the tax benefits of expensing.

2. The large benefits of the investment credit and ACRS deductions will eliminate the tax liability of many corporations, leaving them with excess deductions and credits from which they do not receive full benefit. This creates an incentive for these corporations to merge with taxpaying corporations which can benefit from the otherwise unused deductions and credits.

Arguments against the proposal

1. Tax benefits more generous than expensing are necessary to offset disincentives to investment, such as the double taxation of dividends, and to make up for the shortfall in capital formation that has built up over the past decade.

2. Some businesses may have undertaken or planned investment programs for 1983 that would be profitable after taxes only if investment incentives are not reduced.

3. Adoption of the proposal could mean that some taxpayers would have higher effective tax rates than they had before the enactment of ACRS.

Revenue Effect [1]

[Fiscal years, billions of dollars]

Item	1983 [2]	1984	1985	1986	1987
Reduction to 4 and 7 percent	2.3	5.6	7.1	8.2	9.3
Reduction to 5 and 8 percent	1.5	3.5	4.4	5.1	5.8

[1] These estimates do not take into account interaction with safe-harbor leasing.
[2] Assumes effective date of Jan. 1, 1983.

c. 1985 and 1986 accelerations of depreciation under ACRS

Present Law

Under ACRS, the cost of personal property (generally, machinery and equipment) is recovered over a period of 15, 10, 5, or 3 years, depending on the type of property. For property placed in service before 1985, these cost recovery deductions are determined according to statutory tables which approximate the result of using the 150-percent declining balance method in early years and the straight-line method in subsequent years.

Cost recovery deductions are scheduled to accelerate further in 1985 and again in 1986. For property placed in service in 1985, these deductions approximate the result of using the 175-percent declining balance method in early recovery years and the sum-of-the-years-digits (SYD) method in subsequent years. For property placed in service after 1985, the deductions approximate the result of using the 200-percent declining balance method in early recovery years and the SYD method in subsequent years.

Possible Proposal

The 1985 and 1986 accelerations of depreciation scheduled for property placed in service after 1984 could be repealed.

Pros and Cons

Arguments for the proposal

1. For most personal property (other than long-lived public utility property), the cost recovery deductions currently allowed under ACRS, in combination with the investment tax credit, generate tax benefits that are more generous than the tax benefits of expensing—that is, full deduction of cost in the year of investment. This results in negative tax rates, which make profitable investments which would not be economic even if there were no income tax. The further acceleration of depreciation would increase the excess of ACRS deductions over expensing, thus further increasing the subsidy for uneconomic and unproductive investment.

2. Investment and economic growth would be retarded in 1984 if these provisions are not repealed since businesses will postpone investment to qualify for more generous deductions.

3. The rapid cost recovery under the ACRS system, especially after 1984, will eliminate the tax liability of many corporations, leaving them with excess deductions and credits from which they do not receive full benefit. This creates an incentive for these corporations to merge with taxpaying corporations, which can benefit from the otherwise unused deductions and credits.

Arguments against the proposal

1. Tax benefits more generous than expensing are necessary to offset disincentives to investment, such as the double taxation of dividends, and to make up for the shortfall in capital formation that has built up over the past decade.

2. In 1981, Congress decided that cost recovery deductions would be liberalized further. Adopting the proposal would result in less investment in modern plant and equipment.

Revenue Effect [1]

[Fiscal years, billions of dollars]

1985	1986	1987
1.5	9.6	17.4

[1] This estimate does not take into account interaction with safe-harbor leasing.

d. Depreciation allowances for structures

Present Law

Under ACRS, the cost of depreciable real property (generally, buildings and structures) is recovered over 15 years. The cost recovery deductions are determined according to tables which approximate the result of using the 175-percent declining balance method (200-percent for low-income housing) in early years and the straight-line method in subsequent years.

Possible Proposals

1. The recovery period could be lengthened to 20 years.
2. Cost recovery deductions could be determined according to tables which approximate the result of using the 125-percent declining balance method (150-percent for low-income housing) in early years and the straight-line method in subsequent years.
3. Cost recovery deductions could be determined by using the straight-line method over a recovery period of 18 years (15 years for low-income housing).

Pros and Cons

Arguments for the proposals

1. A 15-year recovery period for buildings and structures, when combined with highly accelerated depreciation methods, generates excessive tax benefits.
2. Highly accelerated depreciation allowances for residential structures encourage tax-motivated sales of used property. This occurs because the buyer is entitled to use the current market value of the sale for purposes of computing depreciation (which is deductible in full against ordinary income). The seller, however, includes in ordinary income only a portion of the difference between the depreciated basis of the asset and the selling price, since the part of this amount not attributable to depreciation in excess of straight-line is treated as a capital gain.

Arguments against the proposals

1. Some taxpayers already may have planned or undertaken investment programs that would be profitable on an after-tax basis only if tax benefits are not reduced.
2. Any reduction in tax incentives for investment would discourage capital formation which is necessary to make up for the shortfall that has built up over the past decade.

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Revenue Effect

[Fiscal years, billions of dollars]

Item	1983 [1]	1984	1985	1986	1987
1. 20-year life with 175% rate (200% for low-income housing)	.2	1.1	2.5	4.0	5.5
2. 15-year life with 125% rate (150% for low-income housing)	.2	.7	1.4	2.2	3.0
3. Straight-line over 18 years (15 years for low-income housing)	.3	1.2	2.4	4.0	5.6

[1] Assumes effective date of Jan. 1, 1983.

e. Open accounts depreciation system

Present Law

Under ACRS, the cost of personal property (generally, machinery and equipment) is recovered over one of four fixed recovery periods. The recovery allowances are computed using the accelerated percentages set forth in ERTA or percentages derived from the straight-line method. The recovery percentages are applied each year to the original cost of the property.

The ACRS recovery allowances (using both the straight-line and accelerated percentages) for a $100 asset in the 5-year class are shown in the table below. The first-year allowance using the straight-line method is 10 percent of asset cost rather than 20 percent, embedding a half-year convention to account for the average amount of time that an asset is presumed to be in service in the first year. Recovery allowances using the accelerated recovery percentages are shown in the second column of the table. These accelerated recovery percentages are intended to approximate the result of using the 150-percent declining balance method (described below) in the early years of the recovery period and the straight-line method in the later years. A half-year convention is also embedded in these percentages.

Using the 150-percent declining balance method for a 5-year asset, the recovery allowance for the year is determined by applying a constant 30 percent (150 divided by 5) to the cost of the asset as reduced by prior recovery allowances. Because this rate is applied to an amount that declines each year as recovery allowances are taken, the recovery allowance also declines each year. However, the fact that the recovery allowance is always 30 percent of the remaining balance means that the balance is never fully recovered. This is shown in the third column of the table. This result could be averted by switching to the straight-line method at an appropriate time into the recovery period to ensure full recovery of cost by the end of the recovery period, as shown in the last column of the table. A half-year convention is embedded in both of these illustrations of the declining balance method.

ANNUAL RECOVERY ALLOWANCES

Year	Present ACRS		ACRS open account (30-percent rate)	150-percent D.B. straight-line
	Straight-line	Accelerated		
	(1)	(2)	(3)	(4)
1	$10	$15	$15.00	$15.00
2	20	22	25.50	25.50
3	20	21	17.85	17.85
4	20	21	12.50	16.66
5	20	21	8.75	16.66
6	10	----------	6.12	8.33
Total	100	100	86.67	100.00

Under ACRS, the recovery allowances are computed separately for each asset. The taxpayer must keep track of the adjusted basis of each asset for purposes of determining gain on disposition of the property. Thus, a different account may be required for each asset (asset-by-asset accounting).

Possible Proposal

An open account system could be established under ACRS for personal property to replace the present asset-by-asset accounting system for personal property. The accounting system would be similar to the accounting system used in a 1980 Senate Finance Committee bill (H.R. 5829) to revise the depreciation rules. The basic ACRS concepts and recovery periods would be unchanged. Under an open account system, depreciable personal property would be grouped into four classes based on the four ACRS recovery periods (15-, 10-, 5-, and 3-year recovery periods). The cost of all property within a class would be placed in the same account regardless of the year of acquisition. For example, a business which acquires an automobile in each of three consecutive years would place these costs into one open account rather than three separate vintage accounts.

In any taxable year, the cost recovery allowance for a class of assets in an open account would be computed under a declining balance method by applying the same percentage each year to the account balance rather than to each asset. If structured under a 150-percent declining balance system, the constant percentage applied to the account for each class would be 50 percent for 3-year recovery property, 30 percent for 5-year recovery property, 15 percent for 10-year recovery property and 10 percent for 15-year public utility property. The account balance would be increased by additions to the account and decreased by recovery allowances. Because the recovery allowances would be computed by using a declining balance method, the cost of any particular asset in the account would not be completely recoverered by the end of that asset's regular recovery period (as shown in the third column of the table above for a 5-year asset).

Instead of immediately recognizing gain or loss on disposition of an asset, the entire proceeds would reduce the account balance which, in turn, would reduce the amount of cost recovery allowances in the year of disposition and subsequent years. Thus, the taxpayers would not have to keep track of the adjusted basis of any asset in the account.

Pros and Cons

Arguments for the proposal

1. The proposal would simplify accounting by greatly reducing the number of accounts and by making them easier to manage as assets are acquired, depreciated, and disposed of.
2. The open account depreciation system has been recommended by the American Institute of Certified Public Accountants.

Arguments against the proposal

1. Adoption would mean that a taxpayer for several years may need to keep at least 3 different kinds of accounts for determining cost recovery allowances: accounts for prior law, asset-by-asset accounts for ACRS, and open accounts.
2. Because the cost recovery allowance is computed as a constant percentage of the account balance, rather than of the asset cost, the open account system does not allow the entire cost of the asset to be recovered.

Revenue Effect

The revenue effect would depend on the details of the proposal—for example, the declining balance percentages to be applied to the accounts.

2. Safe-Harbor Leasing

Prior Law

Prior to the enactment of ERTA, the law contained rules to determine who owns an item of property for tax purposes when the property is subject to an agreement which the parties characterize as a lease. Such rules are important because the owner of the property is the person entitled to claim cost recovery (depreciation) deductions and investment tax credits.

The prior rules attempted to distinguish between true leases, in which the lessor owned the property for tax purposes, and conditional sales, financing or other arrangements, in which the user of the property owned the property for tax purposes. These rules were not set forth in the Internal Revenue Code. Instead they evolved over the years through a series of court cases, and revenue rulings and revenue procedures issued by the Internal Revenue Service.

Essentially, pre-ERTA law provided that the economic substance of a transaction, not its form, determined who was the owner of property for tax purposes. Thus, if a transaction was, in substance, simply a financing arrangement, it would be treated that way for tax purposes regardless of how the parties chose to characterize it. Lease transactions could not be used solely for the purpose of transferring tax benefits. They had to have a nontax business purpose which, in general, meant that the lessor had to derive a profit independent of tax benefits. Also, the lessor had to retain significant burdens and benefits of ownership.

Revenue Procedure 75–21 (and a series of related revenue procedures) provided requirements that, if met, could allow a letter ruling to be issued by the Internal Revenue Service stating that a transaction was a lease. There guidelines were not a definitive statement of legal principles. If all requirements were not met, a court might still determine that, based upon all the facts and circumstances, the transaction was a lease under general principles set forth in cases and rulings. Rev. Proc. 75–21 applied only to leveraged equipment leases. Other leases were governed by these general principles.

The specific requirements for obtaining a ruling under Rev. Proc. 75–21 (and related revenue procedures) are as follows:

1. *Minimum investment.*—The lessor must have a 20-percent minimum at-risk investment in the property throughout the lease term.

2. *Lease term.*—The lease term must not be more than 80 percent of the useful life of the property; at least 20 percent of the value of the property must remain at the end of the lease.

3. *Pre-tax profits.*—The lessor must have a positive cash flow and a reasonable expectation of profit from the lease independent of tax benefits.

4. *Fair market value options.*—The lessee must not have a right to purchase the property at less than fair market value (i.e., no fixed price purchase option). The lessor must not have a contractual right to require the lessee to purchase the property at the end of the lease (i.e., a put), even at fair market value.

5. *Lessee financing precluded.*—The lessee must not have an investment in the lease and must not lend any of the purchase cost to the owner.

6. *Limited use restriction.*—The use of the property at the end of the term of the lease by a person other than the lessee must be commercially feasible.

In addition, although it is not stated expressly in Rev. Proc. 75–21, the lessor must hold State law title to the property.

Present Law

ERTA provides a new set of rules which represent a major departure from prior law. The purpose of these rules is to permit a transfer of tax benefits, rather than to determine who is the owner of property. Under the new rules, certain transactions involving tangible personal property are treated as leases for Federal income tax purposes regardless of their nontax economic substance. If a transaction meets these safe-harbor requirements, the lessor in the agreement is treated as the property owner for Federal income tax purposes and is entitled to cost recovery deductions and the investment credit.

Under the new rules, for example, a person who has acquired and will use the property, by entering into a nominal sale and safe-harbor lease-back, may, in effect, sell some of the tax benefits associated with the property to a corporation, while retaining all economic benefits and burdens of ownership. This type of transaction has been referred to as a tax benefit transfer. Other transactions not qualifying as leases under Rev. Proc. 75–21 (and related revenue procedures) may also qualify as leases under the safe harbor. The prior law rules remain in effect for transactions not qualifying for the safe harbor or when the safe harbor is not elected.

The requirements for safe-harbor lease treatment are as follows:

1. *Election.*—All parties to the agreement must elect.

2. *Corporate lessors.*—The lessor must be a corporation (other than a subchapter S corporation or a personal holding company), a partnership all of the partners of which are qualified corporations, or a grantor trust with respect to which the grantor and all beneficiaries of the trust are corporations or a partnership comprised of corporations.

3. *Minimum investment.*—The lessor must have a minimum at-risk investment in the property, at all times during the lease term, of at least 10 percent of the adjusted basis of the property. (Under ACRS, property has a zero basis at the end of the recovery period.)

4. *Lease term.*—The lease term must not exceed the greater of 90 percent of the property's useful life or 150 percent of the ADR midpoint life of the property.

5. *Eligible property.*—The property must be "qualified leased property." To be qualified leased property, the property must either be new property eligible for the investment credit, or mass commuting vehi-

cles financed in whole or in part by proceeds of tax-exempt industrial development bonds.

Temporary regulations under ERTA impose additional requirements, including a minimum lease term, a maximum rate of interest, and a fixed repayment schedule on debt.

Possible Proposals

Repeal

The safe-harbor rules could be repealed. There could also be some attempt to codify and clarify prior law rules.

Modification of prior law rules

There could be a restoration of some (but not all) of the prior law rules relating to lease transactions: (1) leases would have to pass a profitability and cash-flow test; (2) lessee financing of the property would be prohibited; (3) the lessor would have to own the property under State law; (4) the lessor's minimum investment would have to be 10 percent of the original cost of the property (or, alternatively, 20 percent); (5) options to purchase the property would be limited to fair market value or at least 10 percent (or, alternatively, 20 percent) of the cost and put options would not be allowed; and (6) the maximum lease term would be 90 percent (or, alternatively, 80 percent) of the useful life of the property. The limited use restriction would not apply.

Alternative proposal

1. Safe-harbor lessors would not be able to reduce their tax liability by more than 50 percent by virtue of tax benefits purchased through safe harbor leasing. Tax benefits denied under this rule could be carried forward and used in subsequent years. This would preclude use of purchased tax benefits to obtain tax refunds by carrying back losses or credits to prior years.
2. The foreign tax credit limitation would be computed as if lessees had claimed deductions sold through safe-harbor leasing.
3. The maximum interest rate on loans made in connection with safe-harbor leases would be limited to the interest rate on tax deficiencies, the prime rate of a local bank, or a reasonable rate established by regulations, whichever is greater.
4. A safe-harbor lessee could lease no more than 90 percent of otherwise eligible property under the safe-harbor rules.
5. As an alternative to item 4, leasing would be targeted to relatively unprofitable, capital-intensive industries with a $25,000 exception.
6. There would be a sunset provision repealing safe-harbor leasing after fiscal year 1985.

Other proposals

1. The at-risk rules relating to tax shelters could be eliminated for closely held corporations with respect to their activities as safe-harbor lessors.
2. Safe-harbor leasing could be denied for public utility property.
3. Lease terms could be limited to the ACRS recovery period.
4. The investment credit could be reduced for property subject to safe-harbor leases.

5. The percent-of-income limits on percentage depletion could be computed without regard to tax benefits sold through safe-harbor leasing.

6. Safe-harbor leasing could be denied for property used predominantly outside the United States by a person not subject to U.S. tax.

7. The alternative capital gains rules could be modified so that safe-harbor leasing cannot be used to increase the benefit from that provision.

8. Safe-harbor leasing could be denied to companies where more than a certain percent of revenues come from Federal subsidies.

9. The rules applying after bankruptcy of safe-harbor lessees could be modified.

10. Safe-harbor leasing could be repealed, or sunset, for mass commuting vehicles.

11. Safe-harbor leasing could be replaced by a refundable investment tax credit.

12. Persons who elect to sell tax benefits through safe-harbor leasing could be limited to a 5-year net operating loss and investment credit carryover period.

13. The amount of property eligible for safe-harbor leasing could be reduced to the extent the lessee's foreign-source income exceeds the cost of eligible property.

Pros and Cons

Arguments for the proposals

1. The public perceives safe-harbor leasing to be inequitable for a variety of reasons, including the following:

   a. The safe-harbor rules permit transactions that are entered into only for tax reduction purposes.

   b. Profitable companies that pay no tax because of large tax benefits are allowed to sell excess tax benefits.

   c. Large profitable companies can purchase sufficient tax benefits to eliminate current tax liability and, by carrying back excess benefits against tax liability from prior years, obtain a substantial tax refund.

   d. Nonbusiness tax benefits, such as personal exemptions, cannot be transferred by individuals and, therefore, safe-harbor leasing creates the perception that tax avoidance or tax reduction is allowed only for businesses.

   e. A side effect of safe-harbor leasing is that users of equipment, by selling tax deductions which reduce taxable income, can increase tax benefits other than ACRS.

   f. Safe-harbor leasing puts some companies in a better position than if the corporate income tax were repealed.

2. The safe-harbor lease rules are an inefficient means of giving users of equipment the benefits of tax deductions and credits they cannot use currently, as indicated by the fact that some of the lost revenue has gone to lessors and third parties. Refundability of tax benefits or direct subsidies would be a more efficient mechanism.

3. Safe-harbor leasing gives companies that do not expect to be taxable for long periods of time incentives to purchase equipment that would be unprofitable on a pre-tax basis.

4. Requiring that the transfer of tax benefits be cast in the form of a lease is unnecessarily complex.

Arguments against the proposals

1. ACRS was intended to encourage modernization of plant and equipment by all companies regardless of their marginal tax rate. Without some form of transferability, companies with large net operating losses and investment tax credits would be denied the tax benefits—and associated competitive advantages—of those tax attributes. Denying such benefits would make the tax system nonneutral with respect to risk.

2. Safe-harbor leasing reduces the number of tax-motivated mergers that might otherwise result if ACRS benefits could not be used by all companies.

3. Safe-harbor leasing is less complicated than prior law leasing.

Revenue Effect

[Fiscal years, billions of dollars]

Item	1982 [1]	1983	1984	1985	1986	1987
Repeal safe-harbor leasing	.8	3.2	5.1	6.7	9.0	11.7

[1] Effective February 20, 1982.

3. Tax Treatment of Mergers and Acquisitions

Present Law

a. Corporate acquisition rules generally

Taxpayers generally may elect to treat a business acquisition as a taxable transaction or as a tax-free reorganization. However, that electivity is generally not express, but turns on the selection of a particular form of corporate transaction. The result is a complex set of rules that can be manipulated by sophisticated taxpayers, yet may penalize the unwary.

In general, present law distinguishes five principal types of nontaxable acquisitive reorganizations; mergers, stock acquisitions, asset acquisitions, forward subsidiary mergers, and reverse subsidiary mergers. There are substantial formal and technical distinctions among those transactions, and the definitions of those transactions are complex.

b. Stock purchase treated as asset purchase

Under present law, no gain or loss is recognized on the receipt by a corporation of property distributed in complete liquidation of an 80-percent owned subsidiary corporation. Generally, the basis of the property distributed in complete liquidation of a subsidiary carries over to the distributee corporation. Certain other tax attributes of the liquidated subsidiary also are carried over to the distributee corporation.

An exception to the general rules for carryover treatment for basis in assets and other attributes is provided for cases which are in substance a purchase of assets from another corporation, i.e., a purchase of a controlling stock interest followed by a timely liquidation of the acquired corporation into the acquiring corporation. If this exception applies, the acquiring corporation's basis in the "purchased" assets is the cost of the stock purchased, adjusted for items such as liabilities assumed, certain cash or dividend distributions to the acquiring corporation, and post-acquisition earnings and profits of the subsidiary. There is substantial uncertainty under present law as to the mechanics of such adjustments. Inappropriate results are obtained in some cases.

c. Recognition of gain on certain post-acquisition distributions

Partial liquidations

Under present law, no gain or loss generally is recognized to a corporation on the distribution of property in partial liquidation. The basis of the property, e.g., for purposes of computing such deductions as depreciation and depletion, to the distributee is generally stepped-up (or down) to the fair market value of the property at the time of the distribution.

When one corporation acquires control (at least 80 percent of the stock) of another corporation, the acquiring corporation may select

assets of the acquired corporation to be distributed in partial liquidation of the acquired corporation's business. The acquired corporation pays no tax on gain attributable to appreciation in the distributed assets except to the extent of past depreciation and other items subject to recapture. The basis of the distributed assets is stepped-up to current fair market value in the hands of the acquiring corporation. The acquiring and acquired corporations are eligible to file a consolidated return and, under the consolidated return regulations, any tax on recapture income attributable to a partial liquidation may be deferred. The result is a step-up in basis for selected assets of the acquired corporation without current tax and a continuation of the tax attributes of the acquired corporation which may be combined with the acquiring corporation on a consolidated return. While it is also true that gain or loss is not recognized to a corporation distributing its assets in a complete liquidation, its tax attributes are terminated in that case and the selectivity inherent under the partial liquidation rules is not present.

Stock redemptions

A corporation selling stock or other property in a subsidiary corporation to a corporate purchaser may seek to avoid the taxable gain that would result from a direct sale by structuring the transaction as a redemption of the selling corporation's stock. If the purchase of stock and its subsequent redemption for appreciated property are pursuant to the same plan, the transaction may be treated as a direct sale of the property, resulting in recognition of gain to the selling corporation. If the transaction is treated as a stock redemption, special rules apply. Under present law, a corporation must generally recognize gain attributable to appreciated property used to redeem stock issued by the corporation. However, this recognition rule is subject to several exceptions. The principal exceptions are for certain redemptions in complete termination of the interest of a shareholder owning for 12 months or longer 10 percent or more of the distributing company and certain redemptions involving distributions of stock or obligations of a corporation in which the distributing corporation had at least a 50-percent interest.

d. Special limitations on carryovers

Corporations are generally allowed to carry net operating losses and unused tax credits forward for 15 years. Generally, the net operating loss and credit carryovers of an acquired corporation are not reduced by reason of another corporation's purchase of control of the acquired corporation if the trade or business of the acquired corporation is continued. In the case of reorganizations, there is a proportionate reduction of loss and credit carryovers whenever the shareholders of the acquired loss corporation have less than a 20-percent continuing interest in the acquiring corporation as a result of the reorganization. Carryovers can be denied, however, if the Internal Revenue Service can show that the principal purpose for the acquisition of control of the corporation was the evasion or avoidance of the Federal income tax.

Under the Tax Reform Act of 1976, the rules relating to net operating loss and credit carryovers were strengthened to deal with "trafficking" in loss corporations. However, in response to widespread criticism

of the complexity of these rules, the Congress has postponed the effective date of the provisions several times. Currently, the 1976 revisions are scheduled to become effective in 1984.

Possible Proposals

a. Comprehensive revision

A comprehensive revision of the rules governing corporate acquisitions could be made to substitute express elections for the current emphasis on corporate formalities. It may be appropriate to require conformity between the treatment of the acquiring corporation and the acquired corporation, allowing nonrecognition of gain to the acquired corporation's shareholders only if the acquiring corporation takes a carryover basis, and allowing the acquiring corporation a step-up in basis only if the transaction is taxable. In addition, the definitions of acquisitive reorganizations could be simplified. For example, the definition of qualifying consideration could be standardized, as could the continuity of interest requirement. In addition, the general rule that a corporate distribution of property is not a taxable event could be re-examined. For example, application of the rule could be narrowed so as to apply only to property that would generate long-term capital gain if sold.

b. Limited revision

An alternative approach could be to retain the basic present law structure governing the taxation of mergers and acquisitions, but to make changes to certain rules to deal with potential abuses. These changes could include restricting the ability of acquiring companies to obtain a selective step-up basis of assets of an acquired corporation, avoiding tax at the acquired corporation's level on transactions that are in substance the sale of assets.

The provisions of existing law providing nonrecognition of gain for a corporation making distributions of appreciated property in partial liquidation could be repealed. Further, the exceptions to the requirement that a corporation must recognize gain on distributing appreciated property (such as stock in a subsidiary) in redemption of its stock, could be eliminated.

The provision of present law treating a corporation acquiring control of another corporation as having purchased the assets of the controlled corporation could be restructured to avoid the complexity and potential unwarranted benefits inherent under the existing rules.

c. Carryover of net operating losses and excess credits

The rules dealing with trafficking of net operating loss carryovers and excess credits could be tightened to deter tax-motivated acquisitions of loss corporations to utilize their unused loss and credit carryovers. One approach would be to reduce a corporation's carryover attributes whenever the shareholders at the time the losses and credits arise do not continue to hold a significant ownership interest in the corporation. An alternative approach would be to limit the income against which loss and credit carryovers may be charged to a percentage of income in the carryover year. The percentage would be based on the portion of the pool of capital of the corporation earning the income which is represented by the assets on which the losses were earlier earned.

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Pros and Cons

Arguments for the proposals

a. Comprehensive revision

1. A comprehensive approach to the complex area of taxable and tax-free acquisitions is required to deal with the inconsistency of present law.

2. The complexity and inconsistent policy of the reorganization definitions need remedial legislation.

b. Limited revision

1. Takeover transactions that have been the subject of recent concern provide opportunities for beneficial tax treatment through specific provisions that permit different treatment for asset transactions following stock acquisitions from that applicable to a direct purchase of assets. Revision of these provisions would not require a comprehensive restructuring of the rules governing corporate acquisitions.

c. Special limitations on carryovers

1. More effective rules are needed to deal with trafficking in loss companies because the incentives provided in ERTA, particularly if the leasing rules are modified, will increase the number of companies with loss carryforwards and excess credits. These companies will be the targets of takeover attempts.

2. The existing rules restricting loss carryovers and excess credits have proven to be ineffective.

Arguments against the proposals

a. Comprehensive revision

1. A comprehensive revision of the corporate acquisition rules would be too difficult an undertaking. Any existing problems are relatively limited in scope.

2. Simplification of the reorganization provisions is a limited goal and should not delay addressing the manipulation and abuse prevalent in the field of taxable acquisitions.

b. Limited revision

1. Consistency requires taxing a distributing corporation on all distributions of appreciated property to its shareholders or not taxing any of such distributions. A more limited proposal would perpetuate the inconsistency of existing law, since it would require such a tax only on stock redemptions but not on dividends or complete liquidations.

2. Present law may preclude avoidance of tax in some cases. The transitory ownership of stock which is redeemed for appreciated property may be treated as a taxable sale of the property by the distributing corporation when the substance of the transaction is examined. Deferral or escape of recapture tax in partial liquidations can be eliminated by amendment of the consolidated return regulations.

3. Taxpayers who have sought to avoid tax under present law would urge that any statutory change would imply that their transactions were tax-free.

c. Special limitations on carryovers

1. The incentives provided in ERTA should not be reduced by restrictions on the use of losses and excess credits which would prevent their benefit from being fully utilized.

2. Restrictions on the free transferability of loss carryforwards make them less marketable and thus penalize those who bore the burden of the losses.

Revenue Effect

It is estimated that the limited proposals relating to recognition of gain on certain distributions and stock purchase treated as asset purchase would increase budget receipts on the average by amounts ranging from $0.5 billion to $1 billion annually during the next several fiscal years.

The proposal relating to special limitations on carryovers is estimated to increase budget receipts because the proposal would reduce loss and credit carryovers that could be used against profits for taxable years after ownership changes have occurred. The amount of the revenue increase is indeterminate because potential stock ownership changes and the generation of future taxable income against which carryovers would otherwise be allowed cannot be estimated with reasonable accuracy. However, the revenue increase could be significant due to the current depressed economic activity and the tax advantages available under existing law for acquisition of loss companies.

4. Foreign Oil and Gas Income

Present Law

Foreign tax credit

U.S. corporations are subject to tax on their income from both U.S. and foreign sources. To the extent that their U.S. tax is attributable to foreign source income, they may offset that U.S. tax with a credit for any foreign income taxes they have paid. Foreign oil and gas income is subject to special rules that are intended to prevent credits for foreign oil extraction taxes from sheltering other income. Under these rules, however, extraction losses from one country do not offset extraction income from other countries. Therefore, for companies with extraction losses in one country, the rules may have the effect of allowing credits for foreign taxes incurred on highly taxed extraction income in a second country to offset U.S. tax on low-taxed oil-related income, such as shipping, refining, and financial services, in a third country.

Low-taxed third country income

Income of foreign subsidiaries of U.S. corporations is not subject to U.S. tax when earned; it is only taxed by the United States when and if it is repatriated as dividends. An exception to this general rule exists for certain tax haven income and tax avoidance transactions (the "subpart F" rules).

Possible Proposals

The country-by-country loss feature of the rule for the foreign tax credit limitation affecting extraction income could be repealed and an appropriate loss recapture rule provided. Oil companies thus would not be permitted to use credits or losses arising out of their foreign oil and gas extraction activities to shelter their other income from U.S. tax. A similar result could be achieved by exempting foreign oil and gas extraction income from U.S. tax and disallowing related deductions and credits.

In addition, the present anti-tax haven rules (subpart F) could be expanded so that oil companies would be subject to tax currently on all their foreign non-extraction oil income related to activities carried on in countries other than those where the oil and gas is extracted or consumed. U.S. tax on foreign shipping income could continue to be deferred to the extent the income is reinvested in shipping assets.

Pros and Cons

Arguments for the proposals

1. The proposals would raise significant revenue mostly from major oil companies who currently pay little or no U.S. tax on their foreign earnings.

2. The special oil and gas foreign tax credit limitation rules do not effectively prevent foreign taxes paid on foreign extraction income

from sheltering non-extraction oil-related income earned in low tax countries. By permitting the oil companies to shelter any nonextraction oil-related income which they are able to divert to low tax countries, such diversion is encouraged. This diversion of income is typically accomplished by having subsidiaries in these countries provide intracompany financial services, oil trading, refining, transshipping and other services.

3. There has been considerable controversy over whether the foreign oil taxes for which oil companies claim the foreign tax credit really are "income taxes" that qualify for the credit or whether they are more properly treated as royalties or excise taxes that may only be deducted. Because these companies have been treating the taxes as eligible for the foreign tax credit they have been sheltering substantially all their foreign income from U.S. tax. A proposal to exempt foreign oil and gas extraction income from tax would make unnecessary the distinction between creditable and noncreditable oil extraction taxes.

4. Independent U.S. refiners and U.S. based oil producers argue that they are at a competitive disadvantage to the major international oil companies whose overseas operations receive the favorable present law treatment.

Arguments against the proposals

1. The per-country special loss feature of the separate oil foreign tax credit limitation was adopted to encourage oil companies to explore in non-OPEC countries in order to diversify their sources of production. Some of this incentive would be removed by the proposal.

2. By increasing the U.S. tax burden on foreign oil income, the cost of imported oil could be raised.

3. The oil companies have argued against an exemption or the taxing of their undistributed low taxed foreign income on the grounds that they would be treated differently than companies in other industries.

4. Taxing undistributed oil-related income would put U.S. based international oil companies at a competitive disadvantage vis-a-vis foreign based companies.

Revenue Effect

[Fiscal years, billions of dollars]

1983	1984	1985	1986	1987
.2	.5	.6	.6	.7

5. Possession Corporations

Present Law

General rules

Certain income that certain U.S. corporations ("possession corporations") earn in Puerto Rico and the possessions of the United States is effectively exempt from Federal income tax. This is accomplished by granting electing U.S. corporations a tax credit equal to (and thus fully offsetting) the U.S. tax attributable to income from the active conduct of a trade or business in a possession, the disposition of a possession business, and investment income related to investments in the possession or the business. The credit is available only if 80 percent or more of the gross income of the corporation for the prior three years was derived from any sources within a possession and 50 percent or more of the gross income of the corporation for the prior three years was derived from the active conduct of a trade or business within a possession.

The election may not be revoked for 10 years without the permission of the Internal Revenue Service. An electing corporation may not join in a U.S. consolidated tax return. Foreign income taxes paid on income which is subject to the special tax credit may not be credited or deducted for Federal income tax purposes.

Dividends that a possession corporation pays to its U.S. parent are eligible for the 100 percent dividends received exclusion, and thus are exempt from tax.

In the Virgin Islands, a somewhat different set of rules applies. Corporate "inhabitants" of the Virgin Islands are exempt from U.S. taxation rather than being eligible for the possession credit.

Transfer of intangibles

Under present law, taxpayers have taken the position that they may make tax-free transfers of intangible assets created in the United States (such as patents, secret processes, and trademarks) to an electing corporation, and that no allocation of income generated by those intangibles to the U.S. parent is required. The view of the Internal Revenue Service is that it may make an allocation to the U.S. parent of all or a portion of the income attributable to the intangibles. This issue is now before the U.S. Tax Court. Because a possession corporation is a domestic corporation, a ruling is not required to obtain tax-free treatment on the transfer.

Possible Proposals

1. The credit could be repealed. Alternatively, one or some combination of proposals 2 through 6 could be adopted.

2. The percentage of gross income that must be derived from an active trade or business could be increased to, for example, 80 percent from 50 percent, thus limiting the amount of passive income a posses-

sion corporation could shelter with the credit. Alternatively, the credit could be disallowed for all or some portion of passive income.

3. A possession corporation could be required to pay a royalty to its U.S. parent for intangibles transferred to it by its parent.

4. The credit could be denied to the extent it applied to U.S. tax imposed on income attributable to intangibles created in the United States. For example, if the IRS determines that 50 percent of a possession corporation's taxable income is attributable to know-how, the possession credit would be limited to 50 percent of taxable income.

5. In order to tie the possession credit more closely to employment, the credit could be limited to an amount equal to a fixed amount of wages paid to employees of the possession corporation. For example, the possession credit could be limited to a percentage of the first $10,000 of wages paid to each employee of the corporation.

6. The credit could be limited to exempt only one-half or some other percentage of the possession income of a possession corporation.

Pros and Cons

Arguments for the proposals

1. While the possession credit has attracted Puerto Rican investment that has increased employment, the revenue cost per affected employee is greater than average wages paid. For example, in 1978, the Federal tax expenditure per Puerto Rican employee averaged $12,667 in all manufacturing industries as compared with an average compensation of possession corporation employees of $10,667. The disparity in some instances was much greater. In intangible intensive industries, such as pharmaceuticals, the tax expenditure in 1978 averaged $43,261 as compared to an average employee compensation of $13,618. Some cutback in the credit increasing its efficiency in increasing employment, or outright repeal of the credit, is therefore warranted.

2. The ability of possession corporations to retain earnings and shelter passive income should be limited. A significant portion of the revenue cost of the possession credit is attributable to passive income.

3. The possible proposals to limit the availability of the possession credit for income from intangibles are justified because no legitimate policy is served by permitting tax-free generation of income related to intangibles developed or created in the United States since that income is not derived from increased Puerto Rican employment or economic activity.

4. The proposal to impose an employment-related limit on the credit would target it more directly at the problem, namely, Puerto Rican unemployment.

Arguments against the proposals

1. Puerto Rico is in a desperate economic condition and any curtailment of incentives to invest there can only make the situation worse. The incentives ERTA provides for U.S. investment have already reduced the relative advantage of possession corporations. Repeal of the credit would insure the loss of tens of thousands of jobs and would trigger economic disaster and political instability.

2. The full incentive now provided by the possession credit is necessary to offset the application of the U.S. minimum wage to a significant portion of the Puerto Rican work force. The minimum wage pushes the real cost of labor in Puerto Rico closer to the mainland level and undercuts Puerto Rico's competitive position as a low wage site for investment.

3. The ability provided by the credit to shelter interest income from tax provides an inducement to deposit funds in Puerto Rican commercial banks. These funds are then available for investment in Puerto Rico. Without this incentive, capital would be more expensive and investment would be hindered.

4. Puerto Rico forgives or reduces its business taxes to attract investment. Any increase in U.S. taxation of this investment through changes in the possession credit would undercut these incentives and would have the effect of transferring revenue from Puerto Rico to the United States Treasury.

Revenue Effect

[Fiscal years, billions of dollars]

Item	1983	1984	1985	1986	1987
Repeal of section 936	[1].7	1.4	1.5	1.6	1.8
Repeal credit for income from intangibles	[1].2	.4	.5	.5	.6
Limit credit to $10,000 per full-time employee	[1].4	.9	1.0	1.1	1.2

[1] Assumes an effective date of Jan. 1, 1983.

D. Excise Taxes

1. Energy Consumption Taxes

Present Law

Overview

Under present law, there are a variety of excise taxes imposed on the consumption of fuels or fuel minerals. These excise taxes include (1) the black lung excise tax on coal, (2) the environmental excise taxes on petroleum and certain chemicals, (3) the excise taxes on the sale of gasoline, diesel fuel and other special fuels, and (4) the excise tax on fuel used in commercial transportation on designated inland and intracoastal waterways. (A 3⅓-percent manufacturers excise tax on electrical energy was repealed by the Revenue Act of 1951.)

Tax on mined coal

The black lung excise tax on coal is $1 per ton in the case of coal from underground mines and 50 cents per ton in the case of coal from surface mines, or if less, 4 percent of the price for which the coal is sold. The receipts from this tax on coal are placed in the Black Lung Disability Trust Fund to pay for benefits to miners who suffer from pneumoconiosis or their survivors.

Environmental taxes

The environmental excise taxes on petroleum and certain chemicals are imposed at a rate of 0.79 cents per barrel on crude oil and imported petroleum products, at a rate of $4.87 per ton on a variety of chemicals produced from petroleum, at a rate of $3.44 per ton for methane, and at various rates on selected inorganic chemicals. The receipts from the environmental excise taxes are deposited in the Hazardous Substance Response Trust Fund which may be used in response to toxic oil and chemical spills and other environmental damage associated with toxic substances.

Motor fuels taxes

Excise taxes of 4 cents per gallon are imposed on motor fuels, with exemptions for various off-highway uses, gasohol (through 1992), and buses. Under present law, these excise taxes are scheduled to be reduced to 1.5 cents a gallon on October 1, 1984. The receipts from these taxes are deposited in the Highway Trust Fund through September 30, 1984.

Inland waterways fuel tax

An excise tax of 6 cents per gallon is imposed on fuel used in commercial transportation on designated inland and intracoastal waterways. The tax is scheduled to increase to 8 cents per gallon on October 1, 1983 and to 10 cents per gallon on October 1, 1985. The receipts from this tax are deposited in the Inland Waterways Trust Fund.

Possible Proposals

There are a number of different ways in which new or additional energy consumption taxes could be imposed on energy consumed in the United States, whether imported or domestically produced. Under any option, part or all of the portion of an energy tax which would be derived from highway motor fuels could be transferred to the Highway Trust Fund.

Btu tax

One option would be to impose a broad-based consumption tax on the production or importation of coal, hydroelectric power, natural gas, nuclear power, and petroleum. Such a tax would be imposed on the basis of the Btu content of the fuel.

Ad valorem tax

An ad valorem tax could be imposed as a percentage of the amount paid for coal, hydroelectric power, natural gas, nuclear power, and petroleum. Such a tax could be imposed on the value at the wellhead, mine, or power plant. Alternatively, the tax could be imposed on the value later in the production and distribution chain.

Motor fuels taxes

The motor fuels excise taxes could be increased from the present 4 cents per gallon to some higher level.

Oil tax

An oil tax could be imposed on the importation of crude oil and petroleum products, or alternatively, on consumption of both imported and domestically produced oil and petroleum products.

Combination of energy taxes

A combination of any of the foregoing options could be constructed to produce an energy consumption tax which would be relatively neutral in its per capita impact on various sections of the United States.

Administration and exemptions

In imposing a broad-based energy tax, it would be necessary to decide several basic issues related to the administration of such a tax. These would include the point in the distribution chain for imposition of the tax, and the exemptions necessary to prevent double taxation or taxation of energy that is lost or reinvested in production of taxable energy.

The options with respect to the point at which such a broad-based energy tax could be imposed are:

(1) on the person first recovering the energy product (as in the windfall profit tax and the excise tax on coal);

(2) on the first purchaser of the energy resource (similar to the windfall profit tax withholding system);

(3) on the person who first uses or processes the crude energy resource (as in the case of the environmental excise taxes);

(4) on the person producing or delivering energy in a consumable form (as is the case with the gasoline tax); or

(5) at whatever point between the producer and the ultimate consumer results in the fewest number of taxpaying entities.

The choice of where the tax is imposed will affect the relative burden of the tax on consumers of various fuels, will determine the number of taxpayers, and may influence the method used to assess and collect the tax. For example, a tax at the wellhead or mine mouth would involve many individual producers and suggest withholding by the first purchaser as a method to collect the tax. In addition, an ad valorem tax at that point would not be imposed on value added by refining or transportation. Alternatively, a tax on producers of consumable energy products could involve fewer taxpaying entities (e.g., refineries rather than oil producers) and suggest a self-assessment system like that used for the gasoline tax. Such a tax would, if imposed on an ad valorem basis, tax value added by refining and transportation.

Because one form of energy may be converted to another or used to produce additional energy, a broad-based energy tax could have exemption provisions to prevent double taxation of energy. Examples to such exemptions in present law are the windfall profit tax exemption for powerhouse fuel, the fuel tax exemption for gasoline sold to producers of gasoline, and the refund or credit rules under the environmental excise taxes. In addition, exemptions could be provided for taxable substances that are not used for energy purposes, such as methane used to produce fertilizer. Finally, an exemption could be provided for exports.

Pros and Cons

Arguments for the proposals

1. Energy consumption has various costs which are not reflected in energy prices and thus are not taken into account by consumers in making decisions about energy consumption. These costs include higher prices which must be paid to foreign producers, decreased national security associated with high oil import levels, the high cost of new power plants, and pollution of the environment. Energy consumption taxes would increase prices to reflect these costs, and thus would reduce these costs as consumption of energy declined.

2. The incentives for lower energy use provided by energy consumption taxes would reduce the need for government subsidies for particular energy projects.

3. An oil import fee would raise the net price to domestic producers of energy and thereby stimulate exploration and production activity with respect to domestic energy sources. This would reduce our dependence on foreign sources of fuel.

4. The tax on gasoline and other highway motor fuels has not been increased since 1959 and thus has decreased as a percentage of gasoline prices and relative to consumer prices generally. However, the costs of highway construction and repairs and other costs paid for by the Highway Trust Fund, which is financed mainly by the motor fuels taxes, have continued to escalate.

Arguments against the proposals

1. Any excise tax on the consumption of energy would lead to an increase in the cost of energy, the rate of inflation, and governmental and private outlays that are indexed for inflation.

2. Any option which is not neutral in its impact on various regions of the country would be unfair to consumers in the more heavily affected areas.

3. Energy taxes (like many consumption-based taxes) are regressive, affecting low-income households relatively more severely than high-income households.

4. Taxation of coal would discourage energy users from switching to coal from oil and gas, and would thus increase our dependence on imported oil.

5. There would be high administrative and compliance costs associated with the establishment of a new tax. For this reason, a new tax might be inappropriate if its revenues are needed only for a few years.

Revenue Effect

[Fiscal years, billions of dollars]

Item	1983[1]	1984	1985	1986	1987
1. *Increase motor fuels taxes by:*					
(a) 2 cents per gallon	1.2	1.7	1.7	1.6	1.6
(b) 5 cents per gallon	3.0	4.2	4.1	4.1	4.1
2. *Tax on imported petroleum:*					
(a) $2 per barrel	3.0	4.3	4.2	4.2	4.2
(b) $5 per barrel	7.4	10.4	10.0	9.9	9.9
3. *Tax on domestic and imported petroleum(1983–1985):*					
(a) $2 per barrel	5.0	8.4	8.4	3.4	------
(b) $5 per barrel	12.3	20.6	20.6	8.2	------
4. *Tax on coal, hydroelectric and nuclear power, natural gas, and petroleum(1983–1985):*					
5 percent of value	6.9	11.9	13.7	5.8	------

[1] Assumes effective date of Jan. 1, 1983.

2. Tobacco Taxes

Present Law

For many years, manufacturers excise taxes have been imposed on cigars, cigarettes, and cigarette papers and tubes manufactured in or imported into the United States. A majority of the revenues from these taxes is raised by the tax on small cigarettes; the present rate for that tax has been in effect since 1951.

The following is a summary of the excise taxes imposed on tobacco products under present law:

Item	Tax Imposed
Cigars:	
Small cigars	$0.75 per thousand.
Large cigars	8½ percent of wholesale price, up to $20 per thousand.
Cigarettes:	
Small cigarettes	4.00 per thousand (8 cents per pack).
Large cigarettes	8.40 per thousand.
Cigarette papers	.005 per 50 papers.
Cigarette tubes	.01 per 50 tubes.

Possible Proposals

1. The excise taxes on cigarettes could be doubled to $8.00 per thousand (16 cents per pack) on small cigarettes and $16.80 per thousand on large cigarettes.

2. The excise tax rate on cigarettes could be indexed for inflation, using either the CPI or the GNP deflator. In lieu of indexing, the tax could be changed to an ad valorem tax equal to a percentage of manufacturer's list price.

Pros and Cons

Arguments for the proposals

1. The present cigarette excise tax rates have not been increased since 1951. Inflation since 1951 has resulted in a substantial decrease in the effective rate of these taxes. A higher tax is therefore appropriate.

2. While excise taxes are generally viewed as affecting the poor more than the wealthy, i.e., as regressive, the tobacco excise taxes are imposed on discretionary purchases. Arguments against such regressive taxes are less persuasive in the case of taxes imposed on discretionary purchases than in the case of taxes applied to necessities.

3. Increasing taxes on cigarettes is consistent with Federal Government policies concerning health hazards of smoking.

Arguments against the proposals

1. Excise taxes imposed at a flat rate are regressive, i.e., they cost the poor a larger percentage of available income than they cost wealthier individuals making the same purchases.

2. Indexing the tax rate would mean more frequent changes, which are likely to make tax administration and compliance more costly and complex.

3. State and local governments impose excise taxes on cigarettes. Increasing the Federal tax rate could preempt possible increases in State and local tax rates.

Revenue Effect

[Fiscal years, billions of dollars]

Item	1983	1984	1985	1986	1987
Double tax on cigarettes	1.2	1.8	1.8	1.8	1.8
Index cigarette tax	.1	.3	.4	.6	.7

3. Alcohol Taxes

Present Law

Under present law, excise taxes are levied on the production or importation of three major types of alcoholic beverages: distilled spirits, wine, and beer. Also, an occupational tax is imposed on persons involved with the production or marketing of alcoholic beverages.

The alcohol excise tax rates have not been increased since 1951 (distilled spirits) and 1955 (wine and beer). The following is a summary of the excise taxes imposed on alcoholic beverages and the alcohol occupational taxes:

ALCOHOLIC BEVERAGE TAXES

Item	Tax Imposed
Distilled spirits	$10.50 per proof gallon.
Beer	$9.00 per barrel generally.[1]
Still wines:	
Up to 14 percent alcohol	$0.17 per wine gallon.
14 to 21 percent alcohol	$0.67 per wine gallon.
21 to 24 percent alcohol [2]	$2.25 per wine gallon.
Champagne and sparkling wines	$3.40 per wine gallon.
Artificially carbonated wines	$2.40 per wine gallon.

[1] $7 per barrel for certain small brewers.
[2] Wines containing more than 24 percent alcohol are taxed as distilled spirits.

ALCOHOL OCCUPATIONAL TAXES

Item	Tax Imposed
Brewers	$110 a year; $55 for less than 500 barrels a year.
Still manufacturers	$55 a year, plus $22 per still.
Wholesale dealers:	
Liquors and wines	$255 a year.
Beer	$123 a year.
Retail dealers:	
Liquors and wines	$54 a year.
Beer	$24 a year.

Possible Proposals

1. The alcoholic beverage excise taxes could be doubled as follows:

Item	Tax Imposed
Distilled spirits	$21.00 per proof gallon.
Beer	$18.00 per barrel generally.[1]
Still wines:	
Up to 14 percent alcohol	$0.34 per wine gallon.
14 to 21 percent alcohol	$1.34 per wine gallon.
21 to 24 percent alcohol[2]	$4.50 per wine gallon.
Champagne and sparkling wines	$6.80 per wine gallon.
Artificially carbonated wines	$4.80 per wine gallon.

[1] $14 per barrel for certain small brewers.
[2] Wines containing more than 24 percent alcohol taxed as distilled spirits.

2. The alcoholic beverage excise tax rates could be indexed for inflation, using either the CPI or the GNP deflator. Alternatively, the taxes could be changed to ad valorem taxes equal to a percentage of manufacturer's list price.

Arguments for the proposals

1. The present excise tax on distilled spirits has not been increased since 1951; the taxes on wine and beer have not been increased since 1955. Inflation since those changes were made has resulted in a decrease in the effective rates of the taxes imposed on alcoholic beverages. An increase in these taxes is therefore appropriate.

2. While excise taxes are generally viewed as affecting the poor more than the wealthy, i.e., regressive, the alcohol excise taxes are imposed on discretionary purchases. Arguments against regressive taxes are less persuasive in the case of taxes imposed on discretionary purchases than in the case of taxes affecting necessities.

Arguments against the proposals

1. Excise taxes imposed at a flat rate are regressive, i.e., they cost the poor a larger percentage of available income than the taxes cost wealthier individuals making the same purchases.

2. Indexing the tax rates would mean more frequent changes, which are likely to make tax administration and compliance more costly and complex.

3. State and local governments impose excise taxes on alcoholic beverages. Increasing the Federal tax rates could preempt possible tax increases at the State and local levels.

Revenue Effect

[Fiscal years, billions of dollars]

Item	1983	1984	1985	1986	1987
Double tax on distilled spirits	1.6	2.6	2.7	2.7	2.8
Index distilled spirits tax	.2	.4	.6	.9	1.5
Double tax on beer	.8	1.2	1.1	1.1	1.1
Index beer tax	.1	.2	.3	.4	.5
Double taxes on wine	.1	.2	.2	.2	.2

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4. Telephone Tax

Present Law

A one-percent excise tax is imposed on amounts paid for local telephone service, toll telephone service, and teletypewriter exchange service. The tax is paid by the user of the service to the person rendering the service, who in turn remits the tax to the government.

An excise tax on telephone service has been in effect in every year since 1941. In 1973, the rate of tax declined from 10 percent to 9 percent, as the first step in a schedule according to which the rate of tax was to decline by one percentage point per year and thus to expire as of January 1, 1982. However, the Omnibus Reconciliation Act of 1980 delayed the final steps of this schedule by one year until January 1, 1983. ERTA further delayed repeal for two additional years, or until January 1, 1985.

Possible Proposals

The rate of tax on telephone service could be increased to two percent or some higher rate. Also, the tax could be made permanent.

Pros and Cons

Arguments for the proposals

1. The telephone excise tax has been in effect since 1941. Accordingly, making the tax permanent is more appropriate than continuing the past trend of the Congress to extend the tax each time its scheduled expiration approaches. Also, making the tax permanent would permit planning on a long-term basis by eliminating uncertainty as to whether the tax would be allowed to expire.

2. The telephone excise tax is easily administered and collected.

Arguments against the proposals

1. The Congress has committed itself on numerous occasions to permitting the telephone excise tax to expire.

2. The cost of telephone service is a necessary expenditure in today's society. As such, it could be inappropriate to impose a special tax on that expenditure.

3. State and local governments make use of excise taxes on telephone services. Thus, increasing the Federal tax rate could preempt possible State or local use of the tax.

Revenue Effect

[Fiscal years, billions of dollars]

Item	1983	1984	1985	1986	1987
2 % tax on telephone services	.3	.5	1.0	1.3	1.5

5. Luxury Taxes

Present Law and Background

Present law

Under present law, there are no special Federal excise taxes that apply to purchases of luxury articles such as expensive jewelry, fur coats, yachts, etc.

Background

Prior law imposed Federal excise taxes on automobiles and certain luxury articles. Examples of these taxes included the following:

(1) A 7-percent manufacturers excise tax on automobiles (10 percent prior to 1965);

(2) A 10-percent retailers excise tax on jewelry, various precious and semi-precious stones, watches, clocks, sterling silverware, silver-plated holloware, and certain other items;

(3) A 10-percent retailers excise tax on articles made of fur on the hide or pelt, and on articles of which fur is the component material of chief value;

(4) A 10-percent retailers excise tax on "toilet preparations" (such as cosmetics), handbags, and luggage;

(5) A 10-percent manufacturers excise tax on radio and television sets, phonographs, records, and certain other items;

(6) An annual $10-per-device occupational tax on persons who maintained or permitted the use of coin-operated amusement devices at any place occupied by them; and

(7) A $250-per-year occupational tax on persons who operated slot machines or other coin-operated gaming devices.

The manufacturers excise tax on automobiles was repealed by the Revenue Act of 1971. Items 2–6 above were repealed by the Excise Tax Reduction Act of 1965, and the occupational tax on slot machines and other coin-operated gaming devices was repealed by the Revenue Act of 1978.

Possible Proposal

A 10-percent excise tax could be imposed on purchases of certain luxury articles. The tax could be applied to the excess of the price of the taxable article over a threshold dollar amount.

Under this proposal, articles subject to tax could include the following:

(1) Coin-operated amusement devices and home video games and software;

(2) Automotive vehicles (other than trucks taxed under sec. 4061), including recreational vehicles and trailers, to the extent that the manufacturer's retail list price exceeds $20,000 (an exemption, as under present law, could be provided for buses generally);

(3) Boats and yachts, to the extent that the manufacturer's retail list price exceeds $10,000 (an exemption could be provided for boats sold for use in transporting persons or property for hire or for use in commercial fisheries);

(4) Jewelry, including watches, to the extent that the retail price exceeds $1,000;

(5) Articles made of fur on the hide or pelt and articles of which fur is the component material of chief value to the extent that the retail price exceeds $1,000.

The taxes on automotive vehicles, boats and yachts, and coin-operated amusement devices and home video games could be imposed on the manufacturer or importer of the taxable article. The taxes on jewelry and fur could be imposed on the retail sale of the taxable article.

Pros and Cons

Arguments for the proposal

1. An excise tax on luxury consumer articles could discourage such purchases and thereby encourage greater savings and investment in more productive assets.

2. Various provisions of the income tax law enable some individuals to reduce substantially their tax liabilities, thereby better enabling them to purchase luxury articles. An excise tax on such articles could assist in providing a fairer overall distribution of the tax burden.

Arguments against the proposal

1. A luxury tax could entail high collection and enforcement costs relative to the amounts of revenue generated.

2. Any tax on "luxury" articles would be arbitrary in that there are disagreements as to the type of articles which should be subject to the tax.

3. An excise tax applying only to certain types of goods would distort consumer expenditures in ways that do not necessarily serve any public purpose.

Revenue Effect

[Fiscal years, billions of dollars]

Item	1983	1984	1985	1986	1987
Amusement devices and video games, 10 percent of price	[1]	[1]	[1]	[1]	[1]
Automotive vehicles, 10 percent of price over $20,000	.1	.1	.2	.2	.2
Boats and yachts, 10 percent of price over $10,000	.1	.1	.1	.1	.1
Jewelry, 10 percent of price over $1,000	([2])	.1	.1	.1	.1
Fur, 10 percent of price over $1,000	([2])	([2])	([2])	([2])	([2])

[1] Not available at this time.
[2] Increase of less than $50 million.

E. Employment Taxes

1. Federal Unemployment Tax (FUTA)

Present Law

Under the Federal Unemployment Tax Act (FUTA), employees are subject to a payroll tax of 3.4 percent on the first $6,000 of wages per employee per year. If a State unemployment insurance law meets requirements of Federal law, employers in that State generally receive a 2.7 percent credit against the Federal tax, for a net Federal tax of 0.7 percent. The net effective Federal tax rate will automatically drop by 0.2 percent (to 0.5 percent) when the general fund of the Treasury is repaid the outstanding loans to the extended benefit account.

States also levy unemployment compensation taxes in order to finance benefit payments. Almost all jurisdictions determine an employer's tax rate under a system of experience rating in which the tax rate depends on total unemployment benefits recently paid to an employer's former employees. Federal law requires that no reduced rate (usually a rate below 2.7 percent) may be assigned to an employer except on the basis of the employer's experience rating.

Both the State and Federal taxes are part of the Federal budget and are deposited in the Federal Unemployment Trust Fund. State tax revenues are used to pay regular State benefits and one-half of the cost of extended benefits. Federal tax revenues are used to pay State and Federal administrative costs and the remaining half of the cost of extended benefits, and to maintain a loan fund from which a State may borrow if it lacks funds to pay State benefits.

Possible Proposals

1. Effective January 1, 1983, the FUTA wage base could be increased to $7,000 and the tax rate could be increased to 3.5 percent. Since many States use the same wage base as FUTA, this would increase State taxes in States with a base currently less than $7,000, as well as Federal taxes. Effective January 1, 1985, the Federal tax rate could be increased to 6.2 percent (a permanent tax of 6.0 percent and an extended benefit tax of 0.2 percent) and the credit to 5.4 percent. This could increase the net Federal tax to 0.8 percent and would require that States could not assign to an employer a tax rate below 5.4 percent except on the basis of experience rating.

2. The FUTA wage base could be increased to $8,000.

Pros and Cons

Arguments for the proposals

1. The unemployment insurance program is seriously underfinanced. Recessions of the 1970s and inadequate State and Federal funding have led to substantial deficits currently being financed through Trust Fund borrowing from the Federal Treasury. Outstanding borrowing from the Treasury was equal to $13.1 billion at the end of fiscal year 1982. Total State debt to the Trust Fund is expected to increase in 1982 because of additional State borrowing.

2. The wage base has not been increased since 1978, so that Federal revenues have not kept up with the increase since that year in benefits and administrative costs.

Arguments against the proposals

1. The FUTA tax is a disincentive to hiring, and raising the tax will have a substantial effect on the employment prospects of low-wage workers.

2. Employment disincentives should not be created during a time of high unemployment.

Revenue Effect

[Fiscal years, billions of dollars]

Item	1983 [1]	1984	1985	1986	1987
1. Increase FUTA tax base to $7,000 and net Federal rate to 0.8 percent	.3	1.5	1.4	([2])	([2])
2. Increase FUTA tax base to $8,000	.6	2.9	2.6	2.0	1.8

[1] Assumes effective date of Jan. 1, 1983.

[2] Not available at this time.

F. Miscellaneous

1. Disallowing Deductions for Drug Dealing

Present Law

Ordinary and necessary trade or business expenses are generally deductible in computing taxable income. A recent U.S. Tax Court case allowed deductions for telephone, auto, and rental expenses incurred in the illegal drug trade. In that case, the Internal Revenue Service had challenged the amount of the taxpayer's deduction for cost of goods (illegal drugs) sold, but did not challenge the principle that such amounts were deductible.

On public policy grounds, the Code makes certain otherwise ordinary and necessary expenses incurred in a trade or business nondeductible in computing taxable income. These nondeductible expenses include fines, illegal bribes and kickbacks, and certain other illegal payments.

Possible Proposal

The Congress could disallow all deductions and credits for amounts paid or incurred in illegal trafficking in drugs listed in the Controlled Substances Act. To preclude possible challenges on Constitutional grounds, the proposal w ld not disallow the adjustment to gross receipts for cost of goods sold.

Pros and Cons

Arguments for the proposal

1. The Congress should treat expenses incurred in the illegal drug business like it treats certain other business expenses that violate public policy, such as bribes and kickbacks.
2. The current State and Federal law criminal fines for illegal drug trafficking are not adequate because they do not necessarily relate to the volume of business conducted.
3. Enforcement of the provision would increase the cost of illegal drug trafficking and thus reduce the volume of such trafficking.

Arguments against the proposal

1. The provision could discourage compliance by those drug dealers who are now complying with the tax law.
2. The proposal would be inadequate because it omits reference to illegal activities other than drug dealing and could lead to an inference that expenses incurred in other illegal activities are deductible.
3. The deduction disallowance would be inconsistent with the general income tax principle that the tax should apply to net income, rather than gross income.

Revenue Effect

[Fiscal years, billions of dollars]

1983	1984	1985	1986	1987
([1])	([1])	([1])	([1])	([1])

[1] Increase of less than $50 million.

III. ESTIMATED REVENUE EFFECTS OF POSSIBLE OPTIONS TO INCREASE REVENUE, FISCAL YEARS 1983–87

[In billions of dollars]

Proposal	1983	1984	1985	1986	1987
I. Provisions Addressed by Administration Proposals					
A. Accounting for long-term contracts	2.0	4.4	4.5	3.9	3.8
B. Tax-exempt bonds for private activities	(2)	.5	1.3	2.6	4.1
C. Taxation of life insurance companies:					
(*a*) Administration proposal [3]	2.5	2.4	2.6	2.7	2.9
(*b*) ACLI proposal [4]	1.4	.7	.....	.....	.....
(*c*) Proposal to change formula for approximate reserve revaluation from $21 to $15 per $1,000 of reserves	.3	.5	.5	.5	.5
(*d*) Annuity tax rules	(5)	(5)	(5)	(5)	(5)
D. Construction period interest and taxes [1]	.5	1.0	1.0	1.0	.9
E. Minimum tax (original February Administration proposal) [1]	2.3	4.8	4.5	3.7	3.8
F. Accelerated corporate income tax payments	1.2	1.1	1.2	.4	.1
G. Business energy incentives	.1	.3	.5	.5	.5
H. Amortization of original issue discount on bonds	.2	.2	.4	.5	.6
I. Stripping of interest coupons from bonds	(2)	.1	.1	.1	.2
J. Medicare tax on Federal employees	.6	.8	.9	1.1	1.3
K. Airport and Airway Trust Fund taxes: [6]					
(*a*) Administration proposal	1.2	1.4	1.5	1.7	1.9
(*b*) Ways and Means Committee bill (H.R. 4800)	.4	.1	.....	.....	.....
L. Withholding on interest and dividends	2.3	2.0	2.4	2.8	3.3
II. Other Proposals					
A. Compliance (S. 2198)	2.2	3.4	4.7	5.7	6.4
B. Income tax proposals primarily affecting individuals:					
1. *Tax-qualified pension plans and railroad retirement benefits:*					
(*a*) Limits on contributions and benefits	.3	.8	.9	1.1	1.3
(*b*) Loans to plan participants	(2)	(2)	(2)	(2)	(2)

III. ESTIMATED REVENUE EFFECTS OF POSSIBLE OPTIONS TO INCREASE REVENUE, FISCAL YEARS 1983-87—Continued

[In billions of dollars]

Proposal	1983	1984	1985	1986	1987
(*c*) Integration with social security	(5)	(5)	(5)	(5)	(5)
(*d*) Tier II railroad retirement benefits	.1	.2	.2	.2	.2
2. Public utility dividend reinvestment plans	.1	.4	.4	.3	.....
3. *Exclusion for employer health plan payments:*					
(*a*) $200/month cap for family coverage:					
i. Indexed for CPI	(9)	1.9	3.3	4.1	4.9
ii. Not indexed	(9)	1.9	3.5	4.7	6.0
(*b*) $150/month cap for family coverage:					
i. Indexed for CPI	(9)	4.4	7.6	9.4	11.3
ii. Not indexed	(9)	4.4	8.1	10.8	13.7
4. *Deduction limitation for nonbusiness, nonmortgage interest (single/married):*					
$1,000/$2,000	.4	3.0	3.2	3.4	3.7
$1,500/$3,000	.3	2.1	2.2	2.4	2.5
$2,000/$4,000	.2	1.5	1.6	1.7	1.9
5. *Deductions for sales and personal property taxes:*					
(*a*) Repeal sales tax deduction	.8	5.2	5.8	6.6	7.5
(*b*) Repeal personal property tax deduction	.1	.6	.6	.7	.7
6. *Medical expense and casualty loss deductions:*					
(*a*) Repeal separate deduction for health insurance and increase floor under medical deduction to:					
i. 5 percent	.3	1.8	2.0	2.1	2.3
ii. 10 percent	.4	3.0	3.2	3.5	3.8
(*b*) Place percentage-of-income floor under casualty loss deduction:					
i. 5 percent	.....	.5	.6	.6	.7
ii. 10 percent	.....	.7	.7	.8	.9
7. *July 1983 rate reduction and indexing:*					
(*a*) Repeal July 1, 1983, rate reduction	7.2	32.4	34.9	36.9	40.0

III. ESTIMATED REVENUE EFFECTS OF POSSIBLE OPTIONS TO INCREASE REVENUE, FISCAL YEARS 1983–87—Continued

[In billions of dollars]

Proposal	1983	1984	1985	1986	1987
(*b*) Delay July 1, 1983, rate reduction to Oct. 1, 1983	6.7	.3	.....	.....	.....
(*c*) Delay July 1, 1983, rate reduction to Jan. 1, 1984	7.2	7.1	.....	.....	.....
(*d*) Repeal July 1, 1983, rate reduction and replace with two 5% rate reductions on July 1, 1983, and July 1, 1984, with indexing delayed to Jan. 1, 1986	3.5	12.1	8.8	14.4	15.5
(*e*) Repeal July 1, 1983, rate reduction and advance indexing to July 1, 1983	4.3	13.5	11.9	12.8	14.1
(*f*) Repeal July 1, 1983, rate reduction and advance indexing to Jan. 1, 1984	7.2	23.7	20.6	21.9	23.9
C. Income tax proposals primarily affecting corporations:					
1. *Capital cost recovery:* [11]					
(*a*) Basis adjustment for investment credits:					
i. Basis adjustment for 100% of credits	.8	2.7	5.0	8.1	11.1
ii. Basis adjustment for 50% of credits	.4	1.3	2.5	4.0	5.5
(*b*) Reduction in regular investment credit to:					
i. 4 and 7 percent	2.3	5.6	7.1	8.2	9.3
ii. 5 and 8 percent	1.5	3.5	4.4	5.1	5.8
(*c*) Repeal of 1985 and 1986 accelerations of depreciation under ACRS	.....	.....	1.5	9.6	17.4
(*d*) Reduced depreciation allowances for structures:					
i. 20-year life with 175% rate (200% for low-income housing)	.2	1.1	2.5	4.0	5.5
ii. 15-year life with 125% rate (150% for low-income housing)	.2	.7	1.4	2.2	3.0

III. ESTIMATED REVENUE EFFECTS OF POSSIBLE OPTIONS TO INCREASE REVENUE, FISCAL YEARS 1983–87—Continued

[In billions of dollars]

Proposal	1983	1984	1985	1986	1987
iii. Straight-line over 18 years (15 years for low-income housing)	.3	1.2	2.4	4.0	5.6
(*e*) Open accounts depreciation system	(7)	(7)	(7)	(7)	(7)
2. Repeal safe-harbor leasing [10]	3.2	5.1	6.7	9.0	11.7
3. *Tax treatment of mergers and acquisitions:*					
(*a*) Recognition of gain on certain distributions					
(*b*) Stock purchase treated as asset purchase	.5 to 1.0 annually				
(*d*) Reorganizations constituting changes in form					
(*c*) Special limitations on carryovers	(8)	(8)	(8)	(8)	(8)
4. Foreign oil and gas income	.2	.5	.6	.6	.7
5. *Possession corporations:*					
(*a*) Repeal of section 936	.7	1.4	1.5	1.6	1.8
(*b*) Repeal credit for income from intangibles	.2	.4	.5	.5	.6
(*c*) Limit credit to $10,000 per full-time employee	.4	.9	1.0	1.1	1.2
D. Excise taxes:					
1. *Energy consumption taxes:*					
(*a*) Increase motor fuels taxes by:					
i. 2 cents per gallon	1.2	1.7	1.7	1.6	1.6
ii. 5 cents per gallon	3.0	4.2	4.1	4.1	4.1
(*b*) Tax on imported petroleum (1983–1985):					
i. $2 per barrel	3.0	4.3	4.2	4.2	4.2
ii. $5 per barrel	7.4	10.4	10.0	9.9	9.9
(*c*) Tax on domestic and imported petroleum (1983–1985):					
i. $2 per barrel	5.0	8.4	8.4	3.4	.....
ii. $5 per barrel	12.3	20.6	20.6	8.2	.....
(*d*) Tax on coal, hydroelectric and nuclear power, natural gas, and petroleum:					
5 percent of value	6.9	11.9	13.7	5.8	.....

III. ESTIMATED REVENUE EFFECTS OF POSSIBLE OPTIONS TO INCREASE REVENUE, FISCAL YEARS 1983–87—Continued

[In billions of dollars]

Proposal	1983	1984	1985	1986	1987
2. *Tobacco taxes:*					
Double tax on cigarettes	1.2	1.8	1.8	1.8	1.8
Index cigarette tax	.1	.3	.4	.6	.7
3. *Alcohol taxes:*					
Double tax on distilled spirits	1.6	2.6	2.7	2.7	2.8
Index distilled spirits tax	.2	.4	.6	.9	1.5
Double tax on beer	.8	1.2	1.1	1.1	1.1
Index beer tax	.1	.2	.3	.4	.5
Double taxes on wine	.1	.2	.2	.2	.2
4. 2% tax on telephone services	.3	.5	1.0	1.3	1.5
5. *Luxury taxes:*					
Amusement devices and video games, 10% of price	[5]	[5]	[5]	[5]	[5]
Automotive vehicles, 10% of price over $20,000	.1	.1	.2	.2	.2
Boats and yachts, 10% of price over $10,000	.1	.1	.1	.1	.1
Jewelry, 10% of price over $1,000	([2])	.1	.1	.1	.1
Fur, 10% of price over $1,000	([2])	([2])	([2])	([2])	([2])
E. Employment taxes:					
1. Federal unemployment tax (FUTA):					
(*a*) Increase FUTA tax base to $7,000 and tax rate to 3.5%	.3	1.5	1.4	([5])	([5])
(*b*) Increase FUTA tax base to $8,000	.6	2.9	2.6	2.0	1.8
F. Miscellaneous:					
1. Disallowing deductions for drug dealing	([2])	([2])	([2])	([2])	([2])

[1] Figures reflect Administration estimate.
[2] Increase of less than $50 million.
[3] Increases 1982 fiscal year receipts by $.9 billion (effective as of Jan. 1, 1982).
[4] The proposal is only for a two-year stopgap period (1982 and 1983). Increases 1982 fiscal year receipts by $.5 billion.
[5] Not available at this time.
[6] Net increase in revenues over present-law taxes.
[7] The revenue effect would depend on the details of the proposal—for example, the declining balance percentages to be applied to the accounts.
[8] Indeterminate, but possibly significant, gain.
[9] Assumes an effective date of Jan. 1, 1984.
[10] Increases 1982 fiscal year receipts by $.8 billion (effective date of February 20, 1982).
[11] These estimates do not take into account interaction with safe-harbor leasing.

APPENDIX

Estimated Taxable Returns, Total Tax Liability,[1] Average Tax Liability, and Percentage of Taxpayers Who Itemize Deductions in 1983 and 1984 (Under Present Law)

[1981 income levels]

Expanded income [2] (thousands)	1983 law				1984 law [3]	
	Taxable returns (thousands)	Percentage itemizing deductions	Total tax liability (millions)	Average tax liability	Total tax liability (millions)	Average tax liability
Below $5	4,308	49.7	$406	$94	$399	$93
$5 to $10	12,840	16.9	5,743	447	5,477	428
$10 to $15	13,097	18.2	13,159	1,005	12,524	958
$15 to $20	10,745	31.3	18,433	1,715	17,462	1,627
$20 to $30	16,829	45.7	46,534	2,765	44,080	2,624
$30 to $50	13,575	73.2	66,831	4,923	63,833	4,705
$50 to $100	3,581	91.6	40,368	11,273	38,687	10,806
$100 to $200	631	95.7	19,432	30,796	18,656	29,566
$200 and above	165	97.0	16,660	100,970	16,385	99,909
Total	75,770	41.9	227,567	3,003	217,501	2,875

[1] Tax liabilities do not reflect the refundable portion of the earned income credit and are not adjusted for 1981 changes in individual retirement accounts (IRA), capital cost recovery, and other provisions, the effects of which cannot be estimated from tax return data which are presently available.

[2] Expanded income equals adjusted gross income plus excluded capital gains and various tax preference items less investment interest to the extent of investment income.

[3] "Number of taxable returns" and "percentage itemizing deductions" under 1984 law are very similar to figures for 1983 law.

O